Securities Industry Trends

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AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
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# REPORTING ON PHASE II OF THE SEC/SIA STUDY THE ROLE OF REGIONAL BROKER-DEALERS IN THE CAPITAL FORMATION PROCESS

## HIGHLIGHTS

1. The recovery of the new issues market began in 1979 and continued through the first half of 1981. The value of initial public offerings (IPOs) climbed to $536 million in 1979 -- up from $196 million in the previous year -- and rose sharply to $1,472 million in 1980. In the first six months of 1981 alone, initial common stock offerings reached $1,930 million.

2. Regional broker-dealers acted as lead managers in almost 80% of the total number and 56% of the dollar value of IPOs during the 1978-1980 period.

3. Regional firms fulfill an important market-making function in the initial stages of an issue, but their market-making role tends to decline as the issue becomes more seasoned.

4. Regional respondents to the SEC/SBA Broker-Dealer Survey made markets in 12 NASDAQ stocks on average, compared to less than half that number in non-NASDAQ O-T-C issues. The number of stocks a firm made was with issuer size and with broker-dealer revenue and equity capital, up to a certain level.

5. SEC/SBA findings show a consistent pattern between issuer size and industry on the one hand, and the extent of research coverage on the other. The number of research reports produced during the July 1979 - June 1980 period rose with issuer size. High technology companies received the most extensive coverage, accounting for 42% of all research reports on new companies written over this period.

Securities Industry Association
20 Broad Street • New York, N.Y. 10005 • (212) 425-2700

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## Introduction

From a peak of $2,070 million in 1972, the value of initial public offerings (IPOs) of common stock plummeted to $299 million in 1973 and trailed off to $65 million in 1974. IPO volume remained very low throughout most of the decade. A severe contraction in the broker/dealer community coincided with the decline in IPOs.

Clearly, a number of factors contributed to the prolonged dry spell in initial public offerings. Capital formation difficulties were worsened by the 1969 increase in the capital gains tax, while stricter ERISA requirements left institutions -- never enthusiastic purchasers of risky and less liquid new issues -- still more reluctant to invest in such vehicles. Moreover, with rising inflation, individuals shifted away from paper assets to tangible investments in the mid-seventies and the savings rate dropped steadily. However, the SEC and SBA were particularly concerned about the longer term impact of the shakeout in the regional broker/dealer community on small business capital formation. This concern, and the surprising paucity of data on the interrelationship between regional broker/dealers and small business generally, prompted an extensive two-stage study on the role of regional broker/dealers in the capital formation process.

By the time the first phase of this study was completed (see Securities Industry Trends, Vol. VI, No 4 for a synopsis), the IPO market was well along the road to recovery. Initial public offerings reached $1,472 million in 1980, prompting the SEC and SBA to re-examine their initial premise that the period of contraction in the IPO market was largely explained by the consolidation in the regional broker/dealer community. As Table I shows, the volume of new issues increased with gains in stock prices, particularly those indices reflecting smaller capitalized issues. Hence, investor receptivity appears to be the most important determinant of the success of small business in raising capital via equity issues.

Table I

Stock Price Trends and New Issue Volume, 1972-1980
($ Millions)

| | Total New Issues | | Percentage Change | | |
|---|---|---|---|---|---|
| Year | Number | Dollar Value | NYSE Common Stock Index | AMEX Market Value Index | NASDAQ Composite Index |
| 1972 | 499 | $2,070 | 14.3% | 10.3% | 17.2% |
| 1973 | 90 | 299 | (19.6) | (30.0) | (31.1) |
| 1974 | 16 | 65 | (30.3) | (33.2) | (35.1) |
| 1975 | 10 | 58 | 31.9 | 38.4 | 29.8 |
| 1976 | 22 | 131 | 21.5 | 31.6 | 26.1 |
| 1977 | 36 | 144 | (9.3) | 16.4 | 7.3 |
| 1978 | 47 | 196 | 2.1 | 17.7 | 12.3 |
| 1979 | 86 | 536 | 15.5 | 64.1 | 28.1 |
| 1980 | 227 | 1,472 | 25.7 | 41.3 | 33.9 |

Stock prices took off in the latter half of 1975, after the 1973/74 bear market. Many issues were selling at what could only be considered bargains. This was particularly true for the smaller capitalized stocks listed on the AMEX or traded on the NASDAQ system, as indicated by the enormous gains in the AMEX and NASDAQ indices in 1975-76. This trend boded well for new issues, since investor receptivity towards IPOs tends to parallel price movements of smaller capitalized issues in the secondary market.

In 1978, individual investors began venturing back into the equities market in substantial numbers; 1979 and 1980 were memorable years, with the AMEX Market Value Index, reflecting many smaller energy companies, registering an extraordinary 105.4% gain in this two-year period. According to the New York Stock Exchange's 1980 Census of Shareholders, the shareholder population grew by 18% from mid-1975 to mid-1980. Traditionally, the individual investor has shown more interest in IPOs than larger institutional investors.

Insofar as investor receptivity explains the variation in IPO volume, policymakers should direct their attention to the multitude of macroeconomic factors that determine investor receptivity. Unfortunately, such an analysis does not play a major role in the SEC/SBA report, thereby reducing the study's utility for policy purposes. Nevertheless, the report documents the key role that regional firms play in financing small business and maintaining a liquid secondary market in issues of smaller companies. The SEC/SBA study is an important reference source on smaller issuers and their underwriters, and the contribution of regional firms to market-making and securities research. This issue of Trends summarizes Phase II of the SEC/SBA report.

## I. Initial Public Offerings, Issuers and Managing Underwriters

As the SEC/SBA study illustrates, regional broker/dealers play a pivotal role in underwriting new issues of small companies. National firms generally confine themselves to underwriting the IPOs of larger issuers. This is reflected in differences between regional and national broker/dealers with respect to the average size of issues underwritten and the market share of IPOs distributed on a best efforts and firm commitment basis, respectively. Not surprisingly, regional firms are considerably smaller than national firms -- the size discrepancy between regional and national underwriters is considerably greater than that between IPOs managed by each, respectively.

### Average Issue Size

Initial public offerings in which national broker/dealers acted as managing underwriters averaged $10.4 million, while issues managed by regional firms averaged only $3.4 million. Still, regional broker/dealers accounted for almost 80% of the number of IPOs between 1972-1980. The majority of IPOs are issues of small companies; larger companies have recourse to a number of alternative sources of

financing -- bank loans, private placements, etc., and often opt for these alternatives.

## Method of Distribution

Small issue size and greater underwriter risk are closely correlated. Consequently, new issues underwritten on a best efforts basis tend to be those of the smaller issuers, and regional firms underwrite the vast majority of such issues. During the nine-year period 1972-1980, 273 IPOs were underwritten on a best efforts basis; regional firms managed 267 of these issues.

As the table below illustrates, best efforts offerings constituted a significant part of the total number of new offerings, ranging from a high of 60% in 1975 to a low of 9% in 1972. Over the nine-year period as a whole, best efforts distributions accounted for 26.4% of the total number and 10.3% of the dollar value of new issues. From 1977 through 1980, however, best efforts issues increased in relative importance to roughly 48% of the total number of new issues -- just when the IPO market was beginning to regain its importance as a source of long-term capital for new companies.

Table II

Relative Importance of New Issues Distributed on a Best Efforts Basis
($ Thousands)

| | New Issues Distributed On A Best Efforts Basis | | Total New Issues | | Best Efforts Issues As a % of Total New Issues | |
|---|---|---|---|---|---|---|
| Year | Number | Dollar Value | Number | Dollar Value | % of Total Number | % of Dollar Value |
| 1972 | 46 | $ 34,960 | 499 | $2,069,737 | 9.2% | 1.7% |
| 1973 | 19 | 16,049 | 90 | 299,333 | 21.1 | 5.4 |
| 1974 | 8 | 29,559 | 16 | 64,789 | 50.0 | 45.6 |
| 1975 | 6 | 8,900 | 10 | 58,459 | 60.0 | 15.2 |
| 1976 | 4 | 2,277 | 22 | 131,226 | 18.2 | 1.7 |
| 1977 | 17 | 17,168 | 36 | 144,228 | 47.2 | 11.9 |
| 1978 | 26 | 31,760 | 47 | 195,764 | 55.3 | 16.2 |
| 1979 | 42 | 109,336 | 86 | 535,929 | 48.8 | 20.4 |
| 1980 | 105 | 261,939 | 227 | 1,472,417 | 46.3 | 17.8 |
| | 273 | $511,948 | 1,033 | $4,971,882 | 26.4% | 10.3% |

No clear pattern emerges between the vitality of the equities market as a whole -- both primary and secondary markets -- and the relative importance of new issues distributed on a best efforts basis. However, both the number and the dollar value of best efforts issues consistently increased with the revival of the IPO market. Thus, the recovery of the new issues market has benefitted all new companies,

including those considered to be the riskiest to take public.

Issues distributed on a firm commitment basis were relatively more evenly divided between national and regional broker/dealers. National firms acted as managing underwriters in 49% and regionals in 51% of all IPOs distributed by this method from 1972 through 1980; national firms accounted for 27% of the total number of such issues, contrasted with regional firms' 73%. However, there is a good deal of variability in national and regional broker/dealers' respective market share on a year-to-year basis.

TABLE III

IPOs Managed by National and Regional Broker-Dealers
1972 - 1980
($ Thousands)

| | National Broker-Dealer Manager | | Regional Broker-Dealer Manager | | Issues Managed by Regional Broker-Dealers as a % of Total New Issues | |
|---|---|---|---|---|---|---|
| Year | No. Issues | Dollar Value of Issues | No. Issues | Dollar Value of Issues | % of No. of Issues | % of Dollar Value of Issues |
| 1972 | 111 | $ 990,386 | 388 | $1,079,351 | 77.8% | 52.2% |
| 1973 | 19 | 116,471 | 71 | 182,862 | 78.9 | 61.1 |
| 1974 | 2 | 8,749 | 14 | 56,040 | 87.5 | 86.5 |
| 1975 | 5 | 50,159 | 5 | 8,300 | 50.0 | 14.2 |
| 1976 | 11 | 81,590 | 11 | 49,636 | 50.0 | 37.8 |
| 1977 | 6 | 37,815 | 30 | 106,413 | 83.3 | 73.8 |
| 1978 | 9 | 103,725 | 38 | 92,039 | 80.9 | 47.0 |
| 1979 | 13 | 231,685 | 73 | 304,244 | 84.9 | 56.8 |
| 1980 | 38 | 568,415 | 192 | 904,002 | 84.6 | 61.4 |
| Total | 211 | $2,188,995 | 822 | $2,782,887 | 79.6% | 56.0 |

## Issuer Line of Business

Regional broker/dealers have consistently been the dominant managing underwriters of natural resource and high technology issues, underwriting 89% and 77% of the total number and 78% and 63% of the dollar value of these issues, respectively, from 1972 through 1980. While there does not appear to be a compelling rationale for this trend, it may be that the geographic location of such issuers is an important factor. Natural resource firms tend to be concentrated along the Rocky Mountain Overthrust Belt running through the Western states, while high technology firms are clustered in the Silicon Valley outside of San Francisco and within a 15-mile radius of Boston.

Collectively, natural resource and high technology issuers accounted for 35% of the total number and nearly 40% of the dollar value of IPOs from 1972 through 1980. Moreover, the volume of these issues has increased at a considerably faster pace than the overall increase in IPO volume. If this trend continues and regional firms retain their preeminence as managing underwriters of natural resource and high technology issues, their market share of total IPOs will increase proportionately.

## Size of Underwriter

There is a considerable difference between regional and national broker/dealers in terms of size. According to the SEC/SBA study, regional firm respondents to the Broker/Dealer Survey which had managed IPOs between 1972-1980 had a median revenue of $3.9 million in 1979, contrasted with $135.6 million for national broker/dealers. Furthermore, while responding national firms were fairly uniform in size, regionals showed greater variability.

## II. OTC Market-Making in Initial Public Offerings

The first part of this section outlines the characteristics and composition of market-makers; the second explores subjective and objective measures of market quality, both in terms of liquidity and cost of trading. Perhaps the most noteworthy finding in this section is that regional broker/dealer commitment to market-making is greater per dollar of revenue or capital than national broker/dealer commitment.

## Characteristics and Composition of Market-Makers

As the table below shows, the total number of market-makers in a "new" company rises with issuer revenues. However, the mean number of regional market-makers remains fairly constant as company size varies, indicating that the proportion of regional market-makers declines as the total number of market-makers in an issue rises.

### Table IV

### Number of Markets Made in Initial Public Offerings by Revenue of Issuer

| Revenue of Issuers | No. of Issuers | Mean No. of Total Market Makers | Mean No. of Regional Market Makers |
|---|---|---|---|
| Less Than $10 Million | 36 | 7.8 | 4.7 |
| $10 Million - $24.9 Million | 20 | 8.3 | 5.3 |
| $25 Million - $49.9 Million | 15 | 8.3 | 4.8 |
| $50 Million - $99.9 Million | 7 | 8.6 | 5.6 |
| $100 Million - $499.9 Million | 10 | 9.6 | 4.9 |
| $500 Million - and over | 0 | --- | --- |
| Total | 88 | 8.2 | 4.9 |

Similarly, both the mean number of and average position in NASDAQ and non-NASDAQ stocks rises with broker/dealer revenues up to the $10 - $19.9 million range, stabilizing thereafter in the case of NASDAQ stocks and declining for non-NASDAQ issues. In total, regional broker/dealers responding to the SEC/SBA Broker-Dealer Survey made an average of 32 markets in NASDAQ stocks and 14 markets in non-NASDAQ OTC issues and

maintained an average position of $15,500 in NASDAQ and $6,200 in non-NASDAQ OTC stocks.

### Subjective Issuer Appraisals

SEC/SBA findings support the view that regional market-makers play an important role in the initial stages of a new issue, but their market-making role declines as the issuer becomes more established. Generally, the quality ratings assigned by new issuers to markets made in their stock increase with the proportion of regional market-makers and issuers' revenue. The majority of IPO issuers -- 65% -- rated their markets as excellent or good.

### Objective Issuer Appraisals

In an attempt to compare the quality of markets provided by regional and national firms on an objective basis, the authors of the SEC/SBA study constructed a regression model incorporating factors believed to be important determinants of transactional efficiency. The bid-ask spread was utilized as the measure of efficiency, and the independent variables included: NASDAQ volume (proxy for the rate at which transactions occur); mean NASDAQ bid (the price of the stock); the total number of NASDAQ market-makers; issuer revenue; and, a dummy variable introduced to distinguish between national and regional brokers who make markets.

The results proved to be insignificant for the most part, with only the NASDAQ bid price yielding statistically significant coefficients. The ambiguity of these findings suggests that there is no noteworthy difference in the quality of markets made by national and regional firms, and that other variables are more important determinants of the quality of markets made in any one issue.

## III. Patterns of Securities Research

### Size of Issuer

The study notes that research is a component of market efficiency; information enhances efficiency to the extent that asset pricing is improved. The SEC/SBA study points out that certain characteristics of the securities industry encourage research emphasis on large issuers: commission revenues increase in proportion to market capitalization, thereby providing an economic incentive to focus research on larger companies. Moreover, the markets in heavily capitalized issues tend to be more liquid and, therefore, more attractive to institutional investors. Such an emphasis works to the disadvantage of smaller corporations. The relative scarcity of information on such companies translates into reduced demand and discounted prices for issues of smaller companies -- and a higher cost of capital. (To the extent that investors in new issues are less risk-averse than most, however, they may be more willing to shoulder the additional risk occasioned by the scarcity of information.)

This presumed bias against small companies in initiating research coverage is borne out by the high correlation between the number of research reports on new public companies and the revenues of issuers covered. Over the period July 1979 to June 1980, a total of 7 research reports covering new issuers with no revenues were produced; this contrasts with 60 reports covering issuers with revenues of $25 million or more over the same period. Of the 215 research reports produced during this period, regional broker/dealers authored 135, and national firms, a total of 80.

Surprisingly, the results of the broker/dealer survey questionnaire distributed in connection with the SEC/SBA study indicate that many securities firms do not consciously discriminate against small issuers in selecting companies for research coverage. Slightly more than 40% of national broker/dealers and over 60% of regional firms did not refer to an established minimum issuer size criterion in selecting stocks for research coverage. However, many of the reasons which national firms gave for beginning research coverage might reasonably be expected to correlate with larger size. For example, many national broker/dealers indicated that they initiated research coverage because of a more general decision to begin coverage of a particular industry. Presumably, the more prominent firms within a targeted industry are more likely to receive coverage.

Nearly 80% of regional broker/dealers indicated that they began to follow an issue because it was small and/or new and had favorable growth prospects, as contrasted with 67% of national broker/dealers. Regional firms were also motivated to begin research coverage of a particular issue because it had a regional or local investment following.

A clear pattern emerges when IPO issuers researched by brokerage firms are broken down by line of business. High technology issuers figure prominently among researched issuers, accounting for 42% of all reports written during July 1979 to June 1980 -- nearly 70% of which were written by regional firms -- with "other manufacturing" ranking a distant second.

Thus, it seems that regional firms utilize their comparative advantages -- familiarity with new issues and a feel for regional or local investors' preferences -- in selecting issues for coverage.

## Conclusion

As the recent recovery in the IPO market clearly demonstrates, macroeconomic factors such as rates of capital gains taxation, the level and volatility of interest rates, the performance of new companies, etc., are very important to the ability of smaller issuers to raise money from the public. The structure of the securities industry is an important element as well, in that smaller broker/dealers play a vital role in raising capital for new companies and maintaining a liquid secondary market in such issues.

Most of the steps taken to facilitate small business capital formation to date have aimed at ameliorating regulatory burdens. The ceiling on the maximum amount of securities issuable under Regulation A was raised from $500,000 to $1,500,000 in 1978 and Form S-16, a simplified registration statement, was adopted the following year. Such measures are effective and should be encouraged; however, they can only supplement and not replace macro and micro factors in improving the receptivity of the marketplace to new offerings.

The SEC/SBA study is valuable in highlighting the crucial role regional broker/dealers play in raising money for small companies. It contains data not available elsewhere; however, it does not provide any new analytical insights into the important link between regional firms and new companies and is useful primarily as a reference source for regulators and industry professionals.

Elizabeth Rosenthal
Research Associate

# SECURITIES INDUSTRY STATISTICS

VOLUME

| | September 1981 | YEAR-TO-DATE 1981 | September 1980 | YEAR-TO-DATE 1980 | % CHG. Y-T-D 1981 - 1980 |
|---|---|---|---|---|---|
| AVERAGE DAILY SHARE VOLUME ON | | | | | |
| NYSE (MILS.)* | 45.7 | 47.1 | 50.4 | 43.6 | 8.0% |
| AMEX (MILS.)* | 5.5 | 5.5 | 7.9 | 6.1 | (9.8) |
| NASDAQ (MILS.)* | 28.0 | 31.2 | 36.1 | 23.2 | 34.5 |
| REGIONAL EXCHANGE (MILS.)* | N.A. | N.A. | 5.6 | 5.2 | -- |
| DOLLAR VALUE OF SHARES TRADED ON | | | | | |
| NYSE (MILS.) | 28,003 | 299,632 | 35,797 | 266,673 | 12.4 |
| AMEX (MILS.) | 1,871 | 19,245 | 3,182 | 23,740 | (18.9) |
| ODD-LOT SHARES PURCHASED ON NYSE (THOUS.) | 4,670 | 48,217 | 6,251 | 52,249 | (7.7) |
| ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.) | 9,022 | 103,275 | 12,659 | 101,295 | 2.0 |
| NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED | 30.4 | 31.2 | 27.7 | 29.3 | 6.5 |
| CONTRACTS TRADED (THOUS.) | | | | | |
| CBOE OPTIONS | 5,803 | 40,901 | 4,948 | 36,717 | 11.4 |
| AMEX OPTIONS | 3,233 | 25,153 | 2,769 | 20,299 | 23.9 |
| COMMODITY | 8,591 | 68,630 | 8,903 | 64,031 | 7.2 |

* *MONTHLY AVERAGE*

## YIELDS

(MONTHLY AVERAGES)

| | October 1981 | October 1980 | Basis Point Chg. 1981 - 1980 |
|---|---|---|---|
| BOND BUYER INDEX (20 BOND) | 12.83 | 9.11 | 372 |
| CORPORATE BOND YIELDS (MOODY'S) | | | |
| Aaa CORPORATE | 15.40 | 12.31 | 309 |
| Baa CORPORATE | 17.11 | 14.23 | 288 |
| RATIO Aaa CORPS. TO Baa CORPS. | 0.90 | 0.87 | 3 |
| MUNICIPAL BOND YIELDS (MOODY'S) | 12.05 | 8.38 | 367 |

## PRICES

(END OF MONTH)

| | October 1981 | October 1980 | % Change 1981 - 1980 |
|---|---|---|---|
| DOW JONES INDUSTRIALS | 852.55 | 924.49 | (7.8)% |
| STANDARD & POOR'S 500 | 121.89 | 127.47 | (4.4) |
| NYSE COMPOSITE | 70.64 | 73.53 | (3.9) |
| AMEX MARKET VALUE INDEX | 312.02 | 335.99 | (7.1) |
| VALUE LINE COMPOSITE | 137.42 | 142.70 | (3.7) |
| NASDAQ COMPOSITE | 195.24 | 192.78 | 1.3 |

## UNDERWRITING
## (DOLLARS IN MILLIONS)

| CORPORATE FINANCING (Gross New Issues) | September 1981 | Yr.-to-Date 1981 | September 1980 | Yr.-to-Date 1980 | % Change Sept. 1981--Sept. 1980 | % Change Yr.-to-Date 1981 - 1980 |
|---|---|---|---|---|---|---|
| Total | 3,318 | 43,741 | 3,821 | 45,687 | (13.2)% | (4.3)% |
| Competitive | 175 | 3,657 | 614 | 3,917 | (71.5) | (7.4) |
| Negotiated | 3,143 | 40,084 | 3,206 | 41,757 | (2.0) | (4.0) |
| Common Stock | 625 | 12,278 | 1,188 | 8,274 | (47.4) | 48.4 |
| # Of Common Stock Issues | 51 | 713 | 66 | 423 | (22.7) | 68.6 |
| Preferred Stock | 40 | 1,312 | 350 | 2,221 | (88.6) | (40.9) |
| # Of Preferred Stock Issues | 2 | 32 | 5 | 54 | (60.0) | (40.7) |
| Corporate Debt | 2,653 | 30,150 | 2,283 | 35,193 | 16.2 | (14.3) |
| # Of Corporate Debt Issues | 29 | 319 | 39 | 414 | (25.6) | (23.0) |

| MUNICIPAL FINANCING* (Gross New Issues) | October 1981 | Yr.-to-Date 1981 | October 1980 | Yr.-to-Date 1980 | % Change Sept.'81-'80 | % Change Yr.to-Date 1981-1980 |
|---|---|---|---|---|---|---|
| Total | 6,735 | 63,997 | 6,165 | 63,375 | 9.3% | 1.0% |
| Notes | 3,484 | 28,344 | 1,775 | 22,925 | 96.3 | 23.6 |
| Bonds | 3,251 | 35,653 | 4,390 | 40,450 | (26.0) | (11.9) |
| # of Bond Issues | 226 | 3,454 | 728 | 4,855 | (69.0) | (28.9) |
| Negotiated Bonds | 2,210 | 21,900 | 2,230 | 22,740 | (0.9) | (3.7) |
| Revenue Bonds | 2,380 | 24,060 | 2,860 | 25,830 | (16.8) | (6.9) |

*Preliminary Figures

These tables were prepared by Karin Ford

MUTUAL FUNDS
(DOLLARS IN MILLIONS)

| | September 1981 | Yr.-to-Date 1981 | September 1980 | Yr.-to-Date 1980 | % Change, Y-T-D '81--Y-T-D '80 |
|---|---|---|---|---|---|
| NET SALES* | 17.0 | 922.0 | 89.0 | 642.2 | 59.8% |
| NET PURCHASE OF COMMON STOCK* | (133.8) | (237.8) | (38.2) | (2128.0) | 88.8 |
| NET PURCHASE OF OTHER SECURITIES* | (60.0) | 1107.8 | 29.9 | 1894.7 | (41.5) |
| MUTUAL FUND CASH POSITION | 11.4 | -- | 10.1 | -- | -- |

*EXCLUDES MONEY MARKET, MUNICIPAL BOND AND OPTION FUNDS

MARGIN DEBT

| | September 1981 | September 1980 | % Change Sept. '81 -- Sept. '80 |
|---|---|---|---|
| MARGIN DEBT OUTSTANDING ($MILS) | 13,710 | 12,520 | 9.5% |
| NET CHANGE IN MARGIN DEBT ($MILS) | 1,190 | 520 | 128.9 |
| % OF ACCOUNTS WITH EQUITY UNDER 40% | 16% | 11% | -- |

* ALL TIME HIGH

## FINANCIAL DATA FOR NYSE FIRMS DOING A PUBLIC BUSINESS
## (MILLIONS OF DOLLARS)

| | Second Quarter 1981 | Yr.-to-Date 1981 | Second Quarter 1980 | Yr.-to-Date 1980 | % Change S.Q.1981-S.Q.1980 | % Change Yr.-to-Date 1980 |
|---|---|---|---|---|---|---|
| REVENUE | | | | | | |
| SECURITIES COMMISSION INCOME | 1,483 | 2,856 | 1,027 | 2,512 | 44.4% | 13.7 |
| REALIZED AND UNREALIZED GAIN OR LOSS IN TRADING AND INVESTMENT | 1,062 | 2,428 | 1,408 | 1,951 | (24.6) | 24.4 |
| PROFIT OR LOSS FROM UNDERWRITING AND SELLING GROUPS | 494 | 844 | 357 | 559 | 38.4 | 51.0 |
| TOTAL REVENUE | 4,971 | 9,832 | 4,092 | 7,582 | 21.5 | 29.7 |
| TOTAL EXPENSES | 4,342 | 8,535 | 3,298 | 6,517 | 31.7 | 31.0 |
| NET INCOME BEFORE TAXES | 629 | 1,297 | 794 | 1,065 | (20.8) | 21.8 |
| PERCENT OF FIRMS SHOWING LOSS | 15.6% | 15.9% | 14.6% | 17.1% | -- | -- |

## RECENT INTERESTING READING AND STATISTICAL MATERIAL

| ITEM | DESCRIPTION | SOURCE |
|---|---|---|
| International Diversification by U.S. Pension Funds | An analysis of international diversification of U.S. pension funds. Touches on sponsors' motivations, constraints which have limited the outflow of funds in the past, types of foreign assets purchased, and implications regarding the U.S. BOP and financial markets. | Federal Reserve Bank of New York<br>Quarterly Review<br>Autumn, 1981<br>Vol. 6, No. 3 |
| Investing in Japan | A critical view of the Japanese securities markets. Author discusses the prevalence of reciprocity in various forms, limited distribution and pricing practices of public offerings and woefully inadequate efforts in the investor relations area. | The Economist<br>October 9, 1981 |
| Capital Formation Folio | A document consisting of four sections: Capital Formation and Economic Growth; The Current Savings and Investment Climate; The Tax Burden on Capital; and, An Agenda For Economic Growth. Contains extensive figures and tables as well. | Order from:<br>American Council for Capital Formation: Center for Policy Research<br>1919 Pennsylvania Ave,NW<br>Suite 201<br>Washington, DC 20006<br>Cost: $4.50 per copy plus postage |
| Public Policy and Capital Formation | A theoretical discussion of the capital formation process, including the optimal savings rate, determination of the level of capital formation, determinants of savings and investment demand, and the allocation of investment and efficiency of the capital stock. | Federal Reserve Bulletin<br>October, 1981 |

| ITEM | DESCRIPTION | SOURCE |
|---|---|---|
| Borrowing Gets Harder | Discussion of the gloomy outlook for the municipal market coincident with a sharp cutback in federal aid, and the consequences of a default by a major municipal issuer. According to the author, the amount of long-term bonds issued in the tax-exempt market is expected to drop $7.3 billion this year, the sharpest decline in a decade. | Business Week<br>October 26, 1981 |
| Analyzing Americans' Attitudes Toward Taxes | Author synthesizes the results of a number of public opinion polls on the subject of taxation, and draws conclusions re: the importance accorded capital gains tax cuts, attitudes toward income redistribution and business tax reductions, and preferences for income vs. sales taxation. | Tax Notes<br>November 9, 1981 |
| The Impact of Negotiated Rates on the U.S. Securities Industry | Reprint of an address given by Jeffrey M. Schaefer before the Toronto Society of Financial Analysts. Reviews the rationale for unfixing rates in the U.S., anticipated benefits, and actual consequences re: industry structure, institutional and retail commission rates, market fragmentation, etc. | Available on request from:<br>Research Department<br>Securities Industry Association<br>20 Broad Street - 19 Fl.<br>New York, N.Y. 10005 |
| State of the Industry | Reprint of an address given by Jeffrey M. Schaefer before the Internal Audit Seminar. An Overview of past and future trends within the securities industry towards consolidation and concentration, diversification, and capital intensity, and shifting patterns of industry revenues and expenses. | Available on request from:<br>Research Department<br>Securities Industry Association<br>20 Broad Street - 19 Fl.<br>New York, N.Y. 10005 |
| The Final Days of the Wall Street Partnerships | Synopsis of conflicting reactions to the mergers of the last year, and opinions as to the probable future trend in merger activity. | Euromoney<br>October, 1981 |

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Trends

AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
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# THE SIGNIFICANCE OF MERGERS IN VIEW OF RECENT CHANGES IN THE SECURITIES INDUSTRY*

## HIGHLIGHTS

1. The securities industry underwent significant change during the last decade, and as a result competitive relationships and opportunities have been affected. Concentration increased through mergers and liquidations, as surviving firms sought to diversify revenue streams or capitalize more effectively on specialty businesses.

2. Although dividing lines among financial service industries continue to blur, traditional securities services remain distinct lines of commerce for purposes of analyzing the competitive impact of mergers among securities firms.

3. In analyzing broker-dealer mergers, historical market share data tends to obscure, rather than illuminate, the likely competitive effects.

4. In retail brokerage, relative ease of entry, the importance of mobile account executives, and the availability of varying product/service packages to customers suggest that competition continues to be vigorous despite increases in concentration.

5. In some corporate new issue markets, concentration levels are relatively high and entry barriers are steep. However, the value of distribution and the growing power of major issuers and institutional purchasers have provided opportunities to an expanded and differentiated set of investment bankers. Nevertheless, at some point, further mergers involving major investment bankers may invite antitrust challenge.

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* The author of this paper is Dan W. Schneider, Assistant Director, Division of Market Regulation, Securities and Exchange Commission.

## Introduction*

As nearly anyone in the securities industry can attest, the 1970s brought significant change to the industry. Changes in broker-dealer regulation, including the unfixing of commission rates and the introduction of the Securities and Exchange Commission's ("SEC") Net Capital Rule, produced major structural changes in the securities industry. Changes in ERISA requirements enhanced the role of institutional investors, increasing both the average size and daily volume of securities transactions. Together with the advent of negotiated rates, these changes precipitated a steep drop in institutional commission revenues, forcing many firms to reassess the wisdom of specializing in the institutional business.

Moreover, in response to the back-office crises of the late 1960s and Congress's call in 1975 for more efficient market and clearing mechanisms, the exchanges, NASD, clearing agencies and securities firms improved the industry's processing facilities. Finally, as the 70s progressed, the economic environment changed significantly, with interest rates and inflation rising to unprecedented highs.

Most securities firms adapted to the changing environment through diversification via some combination of horizontal or vertical expansion, with many firms achieving diversity through mergers with other broker-dealers. Thus, during the late 70s and early 80s, firms expanded their product lines to include new investment vehicles, such as options, tax shelters, money-market funds, insurance packages and cash management accounts. Indeed, some firms today aim to provide a full range of financial services, though others continue to exhibit product or geographic specialization.

Some observers now suggest that diversification has progressed to such an extent that industry lines have blurred and different kinds of financial institutions have become virtually indistinguishable. Certainly, broker-dealers have penetrated non-securities lines of business in important respects. Likewise, banking institutions provide some services, such as financial advice, asset

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* The SEC, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The statements and views expressed in this article are those of the author.

Many of the points covered in this paper are discussed at length in the Wisconsin Law Review (No. 1, 1981). Interested readers should refer to Schneider, "Evolving Proof Standards Under Section 7 and Mergers in Transitional Markets: The Securities Industry Example," pp. 1-105.

management, and securities custody and certain investment services, traditionally offered exclusively by securities firms. Should distinctions between financial institutions disappear, the competitive effects of further mergers involving financial intermediaries would need to be assessed in a broad context and traditional relevant markets would need to be redefined.

However, in my view, inter-industry competition has not eliminated traditional distinctions, and the incursions across industry lines remain limited. Securities firms have decisive competitive advantages in providing corporate finance and securities brokerage services, and are generally perceived by issuers and investors as the principal source of such services. Registered broker-dealers are subject to federal and state statutes and to unique regulation by the SEC, various national securities exchanges and the NASD. Furthermore, the Banking Act of 1933 excludes banks entirely from many of the lines of commerce in which securities firms engage. Accordingly, certain traditional securities services remain distinct lines of commerce for purposes of merger analysis.

## Legal Standards Under Section 7 of the Clayton Act

Prior to attempting to define the product and geographic dimensions of relevant markets, it is useful to review the pertinent legal standards governing intercorporate mergers. Section 7 of the Clayton Act prohibits a merger or acquisition that may lessen existing or potential competition substantially in at least one properly defined market. Except in those rare instances in which Congress has repealed the antitrust laws, Section 7 constitutes the basic federal statute governing the permissible competitive effect of mergers. As a result, Section 7 has been applied directly both to mergers in unregulated industries and to combinations involving extensively regulated firms, including financial institutions. Although the SEC and the SROs regulate securities markets extensively, Congress has assigned the ultimate responsibility for deciding the competitive impact of securities firm mergers to the judiciary.

As is often observed, Section 7, unlike Sections 1 and 2 of the Sherman Act, is designed to preserve and promote market structures conducive to future competition by enabling judges to assess any likely tendency in the market toward undue concentration. That design requires predictive judgments by federal judges and enforcement agencies concerning the likely effect of particular mergers in well-defined markets.

Traditionally, in predicting the potential effects of proposed mergers, judges have focused on a limited set of market structure characteristics -- primarily, the number of firms in the market and their relative sizes and market positions and, secondarily, any current trends toward concentration and the extent of barriers to entry.

That focus elevated the proof value of market share data and led inevitably to a judicial presumption that any merger involving two sizeable direct competitors in a fairly concentrated market will lessen competition in violation of Section 7. Market share data thus became the centerpiece of merger litigation during the 1960s and early 1970s. Unfortunately, a focus on market shares can obscure a merger's probable effect. Particularly in markets in which competitive strategies, relationships, and opportunities are dynamic -- whether due to deregulation, technological progress, or shifting economics -- reliance on concentration data is bound to produce simplistic and, at times, peculiar enforcement decisions. Indeed, some earlier judicial decisions involved firms with modest market shares in industries experiencing merely some trend towards concentration -- U.S. v. Pabst Brewing Co. (1966) and U.S. v. Von's Grocery Co. (1966).

In contrast, the Supreme Court's more recent antitrust decisions, including those concerning Section 7, discourage analytical short-cuts, except where pernicious problems are involved. Because it emphasizes greater flexibility in competitive analysis, the Supreme Court encourages lower courts to base their assessment of a merger's effects on a wider range of evidence, diluting the importance of market share data. As a result, contemporary proof standards require plaintiffs to demonstrate adverse effects more specifically than in the past and require courts to assess carefully a wider variety of evidence about the economics of the markets under review.

## Assessing the Competitive Effect of Securities Firm Mergers

### Trends Toward Concentration

Data reported publicly indicate that industry concentration increased substantially during the 1970s. The number of NYSE member firms doing a public business dropped from 444 in 1973 to 387 by year-end 1980, a 13% decline.[1/] Concurrently, the largest 25 member firms increased their shares of total NYSE member capital and gross revenues from 50.2% and 47.8% in 1973 to 68.9% and 72.3% in 1980, respectively.[2/]

Not surprisingly, concentration among NYSE member firms in particular product lines increased during the 1970s as well. Data compiled by SIA show an increase of over 45% in the share of securities commissions received by the 25 largest firms from 1973 to 1980. In underwriting markets as well, the 1978 SEC Staff Report data show a 17% increase from 1973 through 1978 in the market share of

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1/ SIA, Securities Industry Trends, Vol. VII No. 3, p. 20 (May 15, 1981).

2/ Id. at p. 21.

underwriting revenues earned by the 10 largest NYSE member firms -- from 45.2% to 52.9%.

Admittedly, these data are imperfect for antitrust enforcement purposes. By 1980, for example, some 2,066 broker-dealers that were not NYSE members did business with public customers. Similarly, the reported underwriting figures include revenue data for municipal securities underwriting and fail to separate management fees from compensation for distribution. As a result, the reported industrywide percentages may misrepresent the actual levels of market concentration among competing firms. More importantly, increasing concentration does not inevitably produce undue concentration; to be meaningful, any general trends must be viewed in light of other evidence about the dynamics of competition in particular markets.

Retail Securities Brokerage -- Dimensions of the Relevant Markets

"Securities brokerage" in this context refers to the cluster of services provided to customers in connection with executing and completing transactions in securities in the secondary market -- custodial services, research, advice, order routing, execution, and clearance and settlement. Broker-dealers vary in size, complexity, and business mix. Within the securities brokerage product market, there are numerous types of sellers differentiated both by product or customer emphasis and by the geographic scope of their operations. Similarly, there are significant variations in size and product/service preferences among public purchasers of brokerage as well.

Institutional customers and "high ticket" individuals often demand from broker-dealers more refined research and portfolio analysis than do ordinary individual investors (retail customers). Similarly, because institutions trade regularly and in large volume, they are able to execute transactions at significantly lower commission rates. Many institutions have specialized needs which require the use of professional investment advisers and special trading facilities. By contrast, most retail customers buy and sell securities less regularly and require less specialized services.

Competition in retail brokerage, as distinct from institutional brokerage, is focused on rivalry for customers' accounts. Because traditional brokerage services for individual customers tend to be sold only in connection with trading and investment decisions, business success in retail brokerage depends largely on transaction volume. Volume sales at retail depend, in turn, on a steady customer base. To establish and solidify the relationship between customer and firm, some firms devote substantial resources to advertising their distinctive features and to attracting, training, and retaining productive account executives (AEs). Of course, the relationship between customer and firm cannot be fixed. Indeed, when an AE changes firms, his or her customers often follow.

This retail rivalry has a localized geographic dimension. Traditionally, local presence has been important to successful local penetration. Unlike commercial banking, however, convenience of location is not essential to maintain an established market share. In fact, customers can use a brokerage firm located a considerable distance from their homes. Moreover, no significant regulatory impediments preclude a firm from moving into a new locale, nor do substantial communication or transportation barriers exist that would make "distant" sales by a broker located outside a purchaser's home city or state economically infeasible. Thus, some firms provide toll free phone lines to expand their market. Accordingly, in many cases it would be unrealistic to restrict analysis of the competitive impact of a horizontal merger involving two retail competitors to narrow geographic pockets in which both firms have adjacent offices. In fact, a national market may constitute a geographic area of effective retail competition, suitable for appraising a merger involving firms with customers nationwide. National full-line firms appear to pursue a nationally-focused competitive strategy in retail selling. Indeed, despite the localized nature of retail broker/customer relationships, major national firms behave as if their principal local competition comes from branch offices of other wirehouses and regional firms.

In short, current evidence suggests that significant segmentation among retail firms does not exist. The frequency, amount, and type of customer activities do not seem to fall into discrete sets, but, instead, appear to vary along a continuum. Moreover, there are numerous sellers in nearly every geographic locale, and localized retail activity involves a wide variety of firms selling generally fungible products through substantially similar facilities. Although particular firms in any locale exhibit differences in geographic reach, customer emphasis and levels of product diversity, these differences do not yet appear to have produced segmented retail businesses. Whether this will remain true in the future is difficult to predict. Conceivably, increased acquisition of full-service firms by non-brokers could accelerate segmentation.

## Retail Brokerage -- Assessing the Competitive Effect of Retail Mergers

Unlike many other industries, retail securities brokerage requires active, personalized sales effort and continuous customer monitoring. Therefore, it is not surprising to find that retail markets exhibit a spectrum of seller styles, strategies and market positions.

Data suggest that mergers involving major wirehouses, while contributing to an apparent increase in concentration among major securities firms, have not fostered an effective oligopoly in brokerage services nor produced the adverse effects often associated with concentrated markets. Indeed, merger activity among

retail brokers appears to have intensified, not impaired, brokerage competition among the major firms. Firms are offering an expanding variety of investment product/service clusters to a variety of purchasers.

Of course, from the retail consumer's viewpoint, it is in local retail markets that the effect of consolidation activity on sales of brokerage services is most critical, since large-scale horizontal mergers of retail firms would affect consumers of retail services most directly at this level. Such mergers, for example, could lead to a reduction in the number of sales outlets available to consumers, as the combined firm consolidates or closes local offices. The combined firm could also reduce the diversity of products or raise product prices.

During the 1970s, however, in many cities, the number of offices and securities services outlets increased, despite mergers involving major firms. The national firms have not acquired an undue percentage share of local markets and barriers to entry into local brokerage markets are low. Indeed, entry appears not only feasible, but attractive and profitable for entrepreneurs that develop specialized, distinctive or imaginative sales approaches. The most recent SEC report on the industry indicates, for example, that at year-end 1980 there were about 125 discount brokers, almost half of which had been in business for less than five years.

This evidence concerning entry conditions suggests that the supply of brokerage services is enough to affect sellers' prices and products. National full-line service firms face effective competition throughout the country from numerous brokers, including some localized and specialized sellers. Moreover, the evidence concerning ease of entry is consistent with evidence that mergers involving large-scale retail networks fail to generate significant economies of scale. Additionally, the loss of key personnel common during mergers means that the combined firm nets less than the sum of the pre-existing firms' parts.

In summary, securities firms' dependence on mobile account executives, together with the apparent lack of significant scale economies in retail brokerage, limits their ability to exercise discretionary market power in any retail selling market. In addition, ease of entry suggests that localized competition among sellers of retail securities services has not been impaired to date, despite increasing concentration. Finally, the possibility of discounted brokerage charges and rebundled product/service packages further confirms that recent changes in the industry have not lessened retail brokerage competition.

## Corporate Underwriting Activities -- Changes in Market Structure

Although mergers involving investment banking firms could affect competition in a number of investment services, a competitive analysis of such mergers should focus on a service sold only by securities firms -- long-term corporate issue management. While banks are involved in private placements and financial counselling, they are barred from managing corporate public offerings by the Glass-Steagall Act. Corporate customers account for the bulk of underwriting and related investment banking services provided by major investment bankers.

Like competition among broker-dealers for brokerage customers, competition among investment bankers for corporate business occurs in multiple arenas and involves several classes of clients. Some firms specialize in particular industries, such as energy or communications. Other firms concentrate on lower rated issuers in particular industries. But, despite such specialty emphases, aggressive rivalry characterizes a wide spectrum in both origination and distribution, as major firms vie for effective links to issuers and investors alike.

Of course, not all types of issues nor all methods of raising capital are economically equivalent. Different financing methods entail functional differences as well as cost differences. Short-term and specialized financing, for example, should be considered submarkets distinct from long-term corporate underwriting. In such specialities, intermediaries are not required to place their capital at risk, i.e., "underwrite" the offering.

During the 1960s, origination was quite concentrated, while distribution exhibited much greater fragmentation and a lower level of concentration. Distributors were less influential in investment banking circles and participated in underwriting on terms set by the originating investment bankers. Active trading during much of the 1960s made the selling task relatively easy, and it was difficult for strong distributors to differentiate themselves by quality of performance. More importantly, the fixed commission structure encouraged distribution firms to focus their competitive resources on brokerage activities and new issue selling rather than on origination.

By about 1970, however, accelerating consolidation among retail firms gave rise to very large distribution firms whose selling facility challenged traditional sources of power in corporate finance activity. As markets collapsed during 1973 and 1974, selling became more difficult and distribution became a more important component of the underwriting process. As a result, distributors' bargaining strength increased relative to the originators. Growth in the value of distribution, together with increasing price sensitivity among both issuers and purchasers,

led to increased syndicate participation for capable sellers. At the same time, the prospect of reduced brokerage revenues under a negotiated commission structure encouraged diversification. As a result of these developments, successful distributors have for some time been able to secure co-management positions, and with those positions have come management experience, exposure to clients, and a slice of the management fee.

Today, the cumulative changes in the size of firms and degrees of "vertical" integration among originators and distributors have produced a relatively more homogeneous set of major underwriters. Nevertheless, there is a limited number of national managers, and important differences in terms of size, background and business emphasis among several sets of firms remain.

An empirical review of the actual underwriting activity of investment bankers from the mid-1970s to 1980 confirms the existence of approximately 20 national managers. By 1977, for example, only 21 firms acted as lead managers of at least one negotiated firm-commitment issue of $25 million -- an issue size reportedly large enough to require significant capital commitment and a wide distribution team. All 21 of those firms were classified as national full line firms or large investment bankers under the SEC/SIA classification scheme. By 1980, using that same measure, 21 firms still comprised the national manager universe, though two new firms appeared and two original members merged with other members.

Firm-Commitment Corporate Issue Management -- Likely Competitive Impact of Recent and Prospective Mergers

The primary public index of firms' relative market positions measure individual firm shares and firm-group shares in lead management and co-management activity according to the dollar volume of securities managed. During 1979 specifically, in total negotiated securities management, the leading four, eight and fifteen firms had 57%, 84% and 96% of lead management activity, and 52%, 77% and 93% of co-management activity, respectively.3/ While the market shares were generally similar for management of equity issues, the concentration levels were somewhat higher for debt issue management -- 60%, 89% and 98% for lead management activity and 55%, 81% and 95% for co-management activity.

Given those concentration levels, the product submarket identified as management of firm-commitment corporate issues cannot be considered highly concentrated by national industrial standards. In every line of firm-commitment management activity, the leading four firms control less than 75%. Nonetheless, the dollar volume

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3/ See XIV Institutional Investor 118-22 (Mar. 1980).

data portray a market structure sufficiently concentrated for a court to enjoin a merger between two of the leading firms. That is, the levels of concentration in either lead management or co-management activity approach or surpass levels of market concentration that existed in several cases involving horizontal mergers found prima facie unlawful by the Supreme Court.

As in brokerage markets, however, concentration data alone should not determine likely effect. In issue management markets, as in brokerage, the dynamics of competition among the various major sellers have been changing and competition appears to be robust.

The increased importance of distribution to successful underwriting has expanded access to investment banking clients and lowered the barriers to entry into issue management activity. Since 1976, several retail houses have demonstrated lead management capability, displacing even some superbracket firms in the tabulations, particularly in negotiated equity issues. This is a function both of structural changes in corporate underwriting markets and of growing pressure from issuers and institutional purchasers. As syndicates have become increasingly dependent on institutional purchases, the bargaining hand of purchasers has strengthened. In addition, issuers have become increasingly savvy and resourceful; they have discovered ways, albeit limited thus far, to raise capital without using intermediaries, and they have become accustomed to dealing with investors more directly.

Given what seem to be changing dynamics in new issue markets, it is difficult to determine the likely effect of prospective mergers involving investment bankers. On the one hand, the increasing degree of "vertical" integration within individual firms suggests that further complementary combinations of distributors with originators could generate firm-scale efficiencies. For example, combining complementary capabilities in one firm could improve distribution mechanisms, reduce delays and information uncertainties in packaging and managing issues, and enable more innovative use of production facilities.

On the other hand, such integration can pose risks to competition. It can, for example, facilitate the use of significant market power by creating opportunities for well-integrated firms to foreclose independent suppliers or wholesalers, by increasing the barriers to entry into the integrated industry, or by enabling a reduced set of fully integrated firms to collude more effectively. The successful consolidation of the five superbracket firms with a complementary partner could well create a five firm market with high entry barriers -- capital, talent, experience, finesse, and distribution facility -- increasing in scale and intensity.

Moreover, one or two fully integrative mergers could trigger a series of reactive mergers among firms not yet fully integrated. Were a single firm to achieve full integration of complementary capabilities on a new scale, other firms could well choose to duplicate the strategy. And, if a series of parallel mergers occurred, entry into either national origination or distribution could be very difficult to achieve.

Such a scenario, of course, remains speculative. Qualitative evidence suggests that mergers involving investment bankers generate significant personnel losses, which can offset the strategic success and projected market position of a complementary combination. Additionally, lost resources can require the affected firm to adjust strategically to the wider procompetitive impact of the transfer of personnel, clients and deals to existing rivals. Indeed, in recent years, mergers and acquisitions appear to have destabilized positions and increased competition in investment banking in some respects. Moreover, changing business opportunities for distributors and other major financial institutions that develop innovative approaches to corporate financing may provide new opportunities for firms not currently in the national management class.

## Conclusion

Evidence of continuing structural evolution in the securities industry, together with recent developments in the Supreme Court's antitrust decisions, suggest that market share data alone is insufficient to demonstrate the competitive impact of securities firm mergers. Despite traditional judicial emphasis on market share data, only a more detailed analysis of the competitive impact will assure reasoned, economically sensible enforcement decisions.

Looking at mergers involving retail brokerage firms, there is considerable evidence that competition in the retail business is abundant despite recent increases in concentration. New entrants have acquired market position, and established firms have diversified their revenue streams or sought to capitalize more effectively on specialty businesses. An expanding range of investment product/service clusters is available to consumers at varying prices through a diverse array of sellers.

In addition, mergers in the past have often generated significant losses of revenue-producing personnel and accounts, offsetting the impact of potentially adverse effects associated with large horizontal mergers.

In national markets for corporate investment services, competition among major investment bankers has intensified and traditional issuer-underwriter relationships have gradually become undone. Changes in the demand for corporate financing and in economic incentives which shape securities firms' business mix have increased the pressure on traditional new issue originators to provide innovative origination services.

However, vertical integration among national underwriters and retail distributors is well under way and concentration levels are relatively high. Therefore, a further round of mergers involving the leading investment bankers could greatly reduce the set of effective competitors and could create significant barriers to entry if these potentially uncompetitive effects are not offset. Consequently, such a merger, even one occurring early on, could invite antitrust challenge and might depend for its legality on evidence of significant resource losses or substantial economies due to the merger.

Dan W. Schneider
Assistant Director
Division of Market Regulation
Securities and Exchange Commission

# SECURITIES INDUSTRY STATISTICS

## VOLUME

| | October 1981 | YEAR-TO-DATE 1981 | October 1980 | YEAR-TO-DATE 1980 | % CHG. Y-T-D 1981 - 1980 |
|---|---|---|---|---|---|
| AVERAGE DAILY SHARE VOLUME ON | | | | | |
| NYSE (MILS.)* | 45.3 | 46.9 | 44.9 | 43.8 | 7.1% |
| AMEX (MILS.)* | 4.2 | 5.4 | 7.1 | 6.2 | (12.9) |
| NASDAQ (MILS.)* | 25.6 | 30.7 | 36.7 | 24.6 | 24.8 |
| REGIONAL EXCHANGE (MILS.)* | 5.9 | 6.1 | 5.5 | 5.3 | 15.1 |
| DOLLAR VALUE OF SHARES TRADED ON | | | | | |
| NYSE (MILS.) | 30,593 | 330,225 | 36,771 | 303,444 | 8.8 |
| AMEX (MILS.) | 1,456 | 20,701 | 3,676 | 27,416 | (24.5) |
| ODD-LOT SHARES PURCHASED ON NYSE (THOUS.) | 4,461 | 52,678 | 6,076 | 58,325 | (9.7) |
| ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.) | 8,959 | 112,234 | 11,943 | 113,238 | (0.9) |
| NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED | 34.4 | 31.6 | 30.9 | 29.5 | 7.1 |
| CONTRACTS TRADED (THOUS.) | | | | | |
| CBOE OPTIONS | 5,196 | 46,097 | 5,545 | 42,262 | 9.1 |
| AMEX OPTIONS | 3,134 | 28,287 | 2,881 | 23,180 | 22.0 |
| COMMODITY | 7,897 | 76,527 | 9,564 | 73,595 | 4.0 |

* *MONTHLY AVERAGE*

## YIELDS

(MONTHLY AVERAGES)

| | November 1981 | November 1980 | Basis Point Change 1981 - 1980 |
|---|---|---|---|
| BOND BUYER INDEX (20 BOND) | 11.95 | 9.56 | 239 |
| CORPORATE BOND YIELDS (MOODY'S) | | | |
| Aaa CORPORATE | 14.22 | 12.97 | 125 |
| Baa CORPORATE | 16.39 | 14.64 | 175 |
| RATIO Aaa CORPS. TO Baa CORPS. | 0.87 | 0.89 | (2) |
| MUNICIPAL BOND YIELDS (MOODY'S) | 11.05 | 8.71 | 234 |

## PRICES

(END OF MONTH)

| | November 1981 | November 1980 | Percent Change Nov. '81 - Nov. '80 |
|---|---|---|---|
| DOW JONES INDUSTRIALS | 888.98 | 969.45 | (8.3)% |
| STANDARD & POOR'S 500 | 126.35 | 137.21 | (7.9) |
| NYSE COMPOSITE | 73.37 | 79.16 | (7.3) |
| AMEX MARKET VALUE INDEX | 332.85 | 365.03 | (8.8) |
| VALUE LINE COMPOSITE | 141.72 | 148.97 | (4.9) |
| NASDAQ COMPOSITE | 201.37 | 204.91 | (1.7) |

## UNDERWRITING
## (DOLLARS IN MILLIONS)

| CORPORATE FINANCING (Gross New Issues) | October 1981 | Yr.-to-Date 1981 | October 1980 | Yr.-to-Date 1980 | % Change Oct.81--Oct.80 | % Change Y-t-D-'81-'80 |
|---|---|---|---|---|---|---|
| Total | 3,664 | 47,405 | 5,241 | 50,915 | (30.1)% | (6.9)% |
| Competitive | 405 | 4,062 | 1,042 | 4,959 | (61.1) | (18.1) |
| Negotiated | 3,259 | 43,343 | 4,199 | 45,956 | (22.4) | (5.7) |
| Common Stock | 717 | 12,995 | 1,603 | 10,749 | (55.3) | 20.9 |
| # Of Common Stock Issues | 63 | 776 | 79 | 491 | (20.3) | 58.0 |
| Preferred Stock | 125 | 1,437 | 534 | 2,695 | (76.6) | (46.7) |
| # Of Preferred Stock Issues | 3 | 35 | 10 | 64 | (70.0) | (45.3) |
| Corporate Debt | 2,822 | 32,973 | 3,104 | 37,471 | (9.1) | (12.0) |
| # Of Corporate Debt Issues | 30 | 349 | 52 | 966 | (42.3) | (63.9) |
| **MUNICIPAL FINANCING* (Gross New Issues)** | **November 1981** | **Yr.-to-Date 1981** | **November 1980** | **Yr.-to-Date 1980** | **% Change Nov.81--No.80** | **% Change Y-t-D-'81-'80** |
| Total | 7,812 | 72,242 | 5,140 | 68,517 | 52.0% | 5.4% |
| Notes | 2,882 | 31,285 | 2,197 | 25,122 | 31.2 | 24.5 |
| Bonds | 4,930 | 40,957 | 2,943 | 43,395 | 67.5 | (5.6) |
| # of Bond Issues | 294 | 3,813 | 367 | 5,227 | (19.9) | (27.1) |
| Negotiated Bonds | 3,430 | 25,720 | 1,970 | 24,710 | 74.1 | 4.1 |
| Revenue Bonds | 3,480 | 27,930 | 1,850 | 27,690 | 88.1 | 0.9 |

*Preliminary Figures

MUTUAL FUNDS
(DOLLARS IN MILLIONS)

| | October 1981 | Year to Date 1981 | October 1980 | Year to Date 1980 | % Chg. Yr.-to-Date 1981 - 1980 |
|---|---|---|---|---|---|
| NET SALES* | 362.0 | 1,308.0 | 160.0 | 802.2 | 63.1% |
| NET PURCHASE OF COMMON STOCK* | (98.5) | (336.3) | 9.8 | (2,118.2) | 84.1 |
| NET PURCHASE OF OTHER SECURITIES* | 272.9 | 1,380.7 | 169.3 | 2,064.8 | (33.1) |
| MUTUAL FUND CASH POSITION | 12.1 | ----- | 9.8 | ----- | ---- |

*EXCLUDES MONEY MARKET, MUNICIPAL BOND AND OPTION FUNDS

MARGIN DEBT

| | October 1981 | October 1980 | % Change Oct. 81 - Oct. 80 |
|---|---|---|---|
| MARGIN DEBT OUTSTANDING ($MILS) | 13,600 | 13,080 | 4.0% |
| NET CHANGE IN MARGIN DEBT ($MILS) (Oct. 81 - Oct. 80) | 520 | 1,770 | (55.6) |
| % OF ACCOUNTS WITH EQUITY UNDER 40% | 12 | 11 | 9.1 |

* ALL TIME HIGH

## FINANCIAL DATA FOR NYSE FIRMS DOING A PUBLIC BUSINESS
## (MILLIONS OF DOLLARS)

| | Third Quarter 1981 | Yr.-to-Date 1981 | Third Quarter 1980 | Yr.-to-Date 1980 | % Change Th. Q 1981-Th. Q 1980 | % Change Yr.-to-Date 1981-1980 |
|---|---|---|---|---|---|---|
| REVENUE | | | | | | |
| SECURITIES COMMISSION INCOME | 1,222 | 4,078 | 1,477 | 3,989 | (17.3%) | 2.2% |
| REALIZED AND UNREALIZED GAIN OR LOSS IN TRADING AND INVESTMENT | 822 | 3,250 | 710 | 2,661 | 15.8 | 22.1 |
| PROFIT OR LOSS FROM UNDERWRITING AND SELLING GROUPS | 323 | 1,167 | 339 | 898 | (4.7) | 30.0 |
| TOTAL REVENUE | 4,524 | 14,356 | 3,630 | 11,212 | 24.6 | 28.0 |
| TOTAL EXPENSES | 4,300 | 12,835 | 3,128 | 9,645 | .37.5 | 33.1 |
| NET INCOME BEFORE TAXES | 224 | 1,521 | 502 | 1,567 | (55.4) | ( 2.9 ) |
| PERCENT OF FIRMS SHOWING LOSS | 45.4% | 25.8% | 10.4% | 14.9% | ---- | ---- |

## RECENT INTERESTING READING AND STATISTICAL MATERIAL

| ITEM | DESCRIPTION | SOURCE |
|---|---|---|
| Big Government and Small Business: The Changing Relationship | A review of federal policies towards small business in the 70s and some optimistic projections for the 80s. Small firms have suffered disproportionately in the past from regulatory and tax policies. However, the Regulatory Flexibility Act of 1980 and the Economic Recovery Tax Act of 1981 have improved the outlook for small business. | Center for the Study of American Business<br>Washington University<br>Campus Box 1208<br>St. Louis, Missouri 63130 |
| "The Tarnished Dream of Interstate Banking" | An article detailing some of the reservations banks have voiced as the era of interstate branching draws nearer. Among the concerns: the declining profitability of retail banking business, difficulties in raising the necessary funds to buy into retail banks and the prospect of home banking. | Institutional Investor<br>November 1981 |
| "Glass-Steagall: The Maginot Approach to Regulation" | A presentation by an SEC Commissioner on Glass-Steagall issues. Commissioner Longstreth advocates selective modification of the legislation, while recognizing that many of the concerns underlying Glass-Steagall are still valid. | Securities and Exchange Commission News<br>October 21, 1981 |
| "The Case of the Spurious Statistic" | A critique of projections by Congressional staffers and several private forecasting firms of the federal tax revenue losses likely to result from the All Savers Program. Authors argue that the Treasury stands to lose much more than S&Ls will gain by the Program. | Forbes<br>October 12, 1981 |

| ITEM | DESCRIPTION | SOURCE |
|---|---|---|
| "Is the Venture Capital Boom in the U.S. Getting Out of Hand?" | An account of recent changes in the venture capital industry. Author questions whether the current euphoria will last and ends on a cautioning note. | Institutional Investor International Edition November 1981 |
| "Sector Trends: Key to Better Market Results" | Summary of an analysis of the relative importance of general market trends, a specific company's investment characteristics and an industry's relative performance in explaining stock price movements. | Pensions and Investment Age November 23, 1981 |
| "Wall Street and Taxes" | Synopsis of a study, entitled: "Stock Prices," in which the authors sought to identify factors which account for stock price trends. While finding a consistent relationship between variations in common stock prices and the expected present value of anticipated post-tax dividends and capital gains from 1955-70, the authors identified a much weaker correlation during the 70s. | Tax Notes November 23, 1981 |
| In the Matter of Part XV of the By-Laws of the Toronto Stock Exchange | An Ontario Securities Commission (OSC) Staff Submission on the issue of fixed vs. negotiated rates in Canada. | The Ontario Securities Commission<br>10 Wellesley Street East<br>Toronto, Ontario<br>Canada M7A 2H7 |
| Submission to the Ontario Securities Commission Respecting the Unfixing of Commission Rates | The Toronto Stock Exchange's position re: the OSC proposal to unfix rates in Canada. Includes the Exchange's recommendation, an analysis of fixed rates and a discussion of the likely consequences of negotiated rates. | The Toronto Stock Exchange<br>234 Bay Street<br>Toronto, Canada M5J 1R1 |

Securities Industry Trends

ANNUAL SUBSCRIPTION
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AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

A8825-1 3/82

Vol. VIII No. 1 March 15, 1982

# AN INDUSTRY DATA BASE AS AN ANALYTICAL TOOL

## HIGHLIGHTS

1. SIA and Data Resources, Inc. ("DRI") are compiling a securities industry data base that will be accessible to SIA members through time-sharing. It will consist of FOCUS broker/dealer data, Capital Market Indicators, and selected DRI macro time series. Quantitative analysis can increase managerial flexibility by providing for a better understanding of identifiable options.

2. Due to securities industry diversification, commissions have declined from 50.0% of gross revenues in 1976 to 27.0% in 1981. The greatest revenue increases are in interest-related revenues, which also produce the greatest incremental costs.

3. Earnings volatility has reduced in relative, if not absolute, terms. Quarterly pre-tax net averaged $190 million for 1976-78 and $460 million for 1979-81. The average quarterly fluctuation in pre-tax net was $103 million in the first period, $193 million in the second. As a percentage of net income, the average fluctuation declined.

4. Industry trading revenues increased by 251% over the 1976-1981 period, accounting for 21% of 1981 gross revenues. Accrued interest in reported trading revenues overstates trading profitability, but fluctuations in trading revenues are clearly the most important single influence on the industry's bottom line.

5. Firms differ both in the extent of their trading commitment and in the type of securities they trade. Trading in debt securities produced 82% of the Large Investment Bankers' 1981 trading revenues, as compared to 45% for Regionals. Regional firms have proportionately the greatest OTC commitment.

6. Large Investment Bankers have had more success than National Full Line or Regional firms in controlling "fixed" costs. For the latter two groups, overhead items have risen since 1978 in step with revenues.

## Introduction

The most publicized industry development of the past year has been, without question, the advent of such non-Wall Street yet awesome competitors as American Express, Phibro, Prudential and Sears Roebuck. Just as Corporate America has been moving closer to the broker/dealer community, so too have broker/dealers been moving closer to Corporate America. A shift in ownership form is one aspect of this broker/dealer evolution; a shift in management style is another. The two are not unrelated. Until a decade or so ago, the management function in the securities industry occupied a very secondary position behind selling and, in some firms, dealing.

Developments on both the regulatory and economic fronts over the past ten or twelve years have imposed upon the larger firms in the industry something like a corporate structure. The almost uniquely labor-intensive nature of the securities industry, however, makes for a very different staff-line tradeoff from what prevails in other financial institutions or in investment banking clients. The ties between a securities firm and its key personnel are far more fragile than, for instance, those between an industrial company and its technological strengths.

Despite these changes, the business remains highly entrepreneurial, and a great premium attaches to sound management intuition. In some quarters, faith in intuition is almost absolute. The industry's growing commitment to trading, in particular, makes a strong sense of market timing essential. Intuitive decisions, however, are based on implicit assumptions as to future levels of interest rates, prices, and volume. Intuition, furthermore, is a very hard thing to transmit or instill. In contrast, a quantitative analytical approach can serve not to lessen management's flexibility but to increase management's understanding of identifiable options. In this way, flexibility can be increased, not decreased.

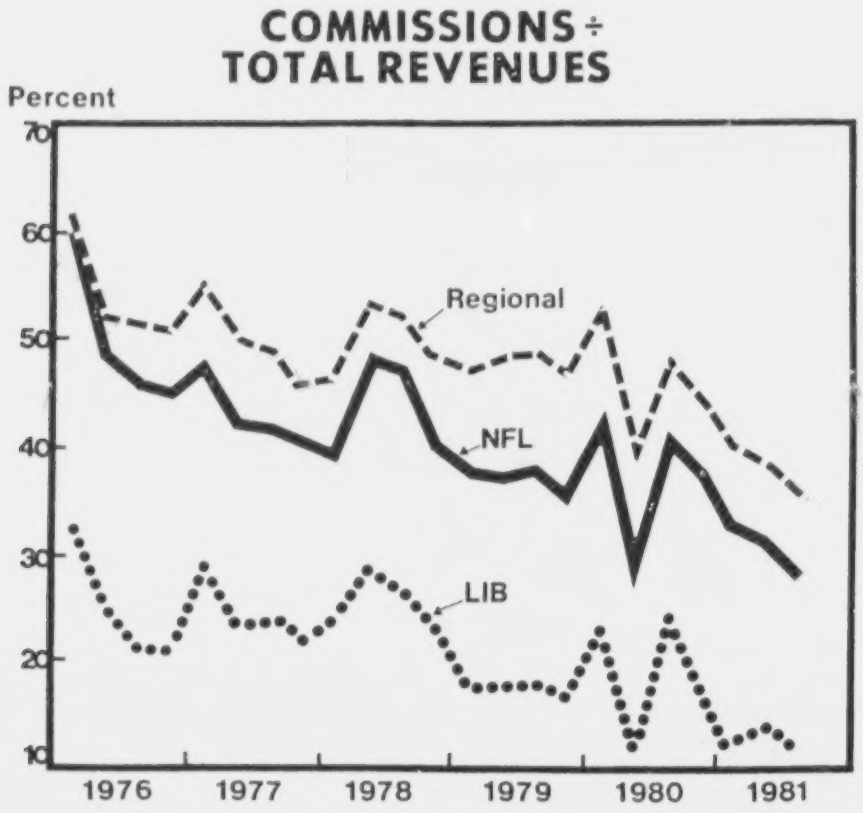
With this in mind, SIA's Research Department and Data Resources, Inc. ("DRI") have undertaken jointly the task of forming a securities industry data base. This data base, when completed, will be in three parts: (1) broker/dealer income statement and balance sheet data from FOCUS; (2) Capital Market Indicators compiled from a broad range of sources; and (3) selected macroeconomic time series from DRI's other data banks. This securities industry data base, conceived as a membership service, will be accessible to SIA members in the near future through a conventional time-sharing arrangement. It has enabled SIA's Research staff -- and will enable member firms -- to plot revenues and expenses against key economic variables, thereby gaining new insights into the determinants of profitability. When attempting any such analysis of the securities industry, it should be kept in mind that strong correlations between different product lines can cloud the importance of both dependent and independent variables. On the whole, though, the securities industry data base represents a major addition to SIA's own research capabilities. The remainder of this Trends issue will discuss findings to date, some of which were introduced at the January 20, 1982 Trends Conference.

## Diversification

Not too long ago, the securities industry resembled somewhat a one-crop economy, the agency equity business being the staple. The industry's recent diversification is most easily expressed in terms of commissions as a percentage of gross revenues, down from 50.0% in 1976 to about 27.0% for 1981. Even this understates the decline, since listed options became an important part (over 10%) of the agency business during this period. The most important factor at work in commissions' relative decline is the exorbitant interest rates that have swollen industry revenue figures. Firms earn interest on margin loans, long positions*, and reverse repurchase agreements. The recent spurt in interest rates has been so great as to alter nearly every income statement relationship.

The chart below shows commissions as a percentage of revenues during 1976-1981 for three categories of firm -- National Full Line, Large Investment Bankers, and Regionals. The three groups' commission revenues move closely in tandem, but still display great differences as to reliance on the commission business. Large Investment Bankers, being the most institutionally- and, hence, principal-oriented, derive the smallest percentage of gross from the commission business.

Chart 1

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* Trading profits reported on FOCUS include accrued interest, grossly overstating the profitability of trading.

Given that commissions have declined steeply in relative importance, it follows that other revenue items have experienced greater growth. The table below indexes revenue increases 1976-1981 for all firms and for the three firm categories. It is clear that the traditional business lines, commissions and underwriting, have grown more slowly than interest-related revenue items such as margin lending and trading. The different growth rates in underwriting revenues for National Full Line and Large Investment Banking firms reflect the growing importance accorded retail distribution strength in recent years. Just the reverse is true, though, in the case of Other Related revenues, which include M&A and Private Placement fees, and the interest earned on matched repos.

Table 1

1981 Securities Industry Revenues Indexed
(1976 = 1.00)

| Revenue Item | All Firms | National Full Line | Large Investment Bankers | Regionals |
|---|---|---|---|---|
| Commissions | 1.69 | 1.69 | 1.68 | 1.79 |
| Trading Profits | 3.51 | 3.54 | 4.19 | 2.82 |
| Margin Interest | 5.32 | 5.09 | 4.66 | 6.32 |
| Underwriting | 1.86 | 2.10 | 1.29 | 2.26 |
| Other Related | 5.48 | 5.49 | 6.71 | 4.26 |
| Gross Revenues | 2.88 | 2.93 | 3.53 | 2.64 |

Revenue growth has not inevitably meant growth in profits, since the related expenses frequently grow in tandem. It is important to consider not just the rates of growth of different revenue items but their relative magnitude as well. Table 2 below gives this breakdown for all firms and for three categories. It is clear that a considerable evolution has occurred in a five-year span, and that various groups appear to be in somewhat different businesses. The income statement similarities between National Full Line and Regional firms reflect their shared retail emphasis. The Large Investment Bankers' relative commitment to the brokerage and underwriting business is strikingly low; their trading activities are very important. The high proportion of "Other Related" revenues is very significant; advisory fees and the interest earned on reverse repos are the most important components of this line item.

A question of the utmost relevance is what impact a sustained drop in interest rates would have on the industry's bottom line. A preliminary analysis suggests it would benefit the institutional at the expense of the retail end of the business, for it would bolster trading while removing much of the benefit of float utilization. A great deal hinges, though, on the impact a drop in rates might have on the demand for equities and traditional investment banking services.

Table 2

Components of Revenue

| | All Firms | | National Full Line | |
|---|---|---|---|---|
| | 1976 | 1981 | 1976 | 1981 |
| Commissions | 45.8% | 27.0% | 50.0% | 29.0% |
| Trading Profits | 17.5 | 21.0 | 14.3 | 17.0 |
| Investment Profits | 2.8 | 3.0 | 0.5 | 1.0 |
| Margin Interest | 7.9 | 15.0 | 11.7 | 20.0 |
| Underwriting | 12.3 | 8.0 | 12.1 | 9.0 |
| Other Related | 7.8 | 15.0 | 3.8 | 12.0 |
| All Other | 5.9 | 11.0 | 7.6 | 12.0 |
| Total | 100.0% | 100.0% | 100.0% | 100.0% |

| | Large Investment Banking | | Regionals | |
|---|---|---|---|---|
| | 1976 | 1981 | 1976 | 1981 |
| Commissions | 24.5% | 12.0 | 54.1% | 37.0% |
| Trading Profits | 30.5 | 36.0 | 14.1 | 15.0 |
| Investment Profits | 5.2 | 6.0 | 0.5 | 1.0 |
| Margin Interest | 3.1 | 4.0 | 7.6 | 18.0 |
| Underwriting | 17.9 | 7.0 | 13.8 | 12.0 |
| Other Related | 12.3 | 24.0 | 5.9 | 9.0 |
| All Other | 6.5 | 11.0 | 4.0 | 8.0 |
| Total | 100.0% | 100.0% | 100.0% | 100.0% |

## Volatility

Diversification has had only mixed success in lowering earnings volatility for the industry, due to the close correlations between different product lines, and to the extremely high risks present in the principal business. Earnings volatility is one of the most basic facts of life in this business. An element of stability comes from the agency and principal businesses' tendency to peak at different times; the first and second quarters of 1980 are a case in point. Recent earnings have been at a higher level and somewhat more stable. Only for the Large Investment Bankers has earnings volatility increased, a function of their business mix.

This increased profitability has meant increased volatility in absolute, if not in relative, terms. Dividing the 1976-81 period in halves, quarterly pre-tax net for the industry is found to have been $190 million in 1976-78, then $460 million for 1979-81. The average quarter-to-quarter difference in net income was $103 million in the first half and $193 million in the second. While

this is a steep absolute rise, the average quarterly swing in net income declined from 54% of average quarterly net in the first half to 42% in the second. Interestingly, there is an almost 50-50 probability as to whether, at any given time, next quarter's profits will be above or below the level of this quarter's. Thus, in predicting the direction of profit swings from one quarter to the next, the forecaster might as well flip a coin.

## Profitability Determinants

Differences in business mix between types of firm suggest differences in profitability determinants as well. These differences, however, are largely matters of degree. The decline in the relative importance of commissions is closely related to the rise of the principal business. For the total industry, fluctuations in trading revenues appear to explain those in net income better than do fluctuations in any other revenue item. The next chart, which indexes trading revenues and net income from the first quarter of 1976 through the third quarter of 1981, makes this clear.

Chart 2

Commissions, however, continue to exert a larger influence on some categories' profit margins than other product lines. The next two charts plot indexed commissions and profit margins 1976-1981 for National Full Line and Regional firms. The similarity of business mix between National Full Line and Regional firms explains the similarity between these two graphs. For both National Full Line and Regional firms, commissions are closely related to profit margin swings. The retail brokerage business inevitably involves some operating leverage, but another factor may be at work here. The margin lending business is closely related to the retail commission business. The burgeoning of free credit balances from $2.5 billion in early 1976 to $10.7 billion at year-end 1981 has changed the margin business from one of relending at a favorable spread to one of utilizing float. This phenomenon may explain some of commissions' bottom line impact and requires further research.

Chart 3

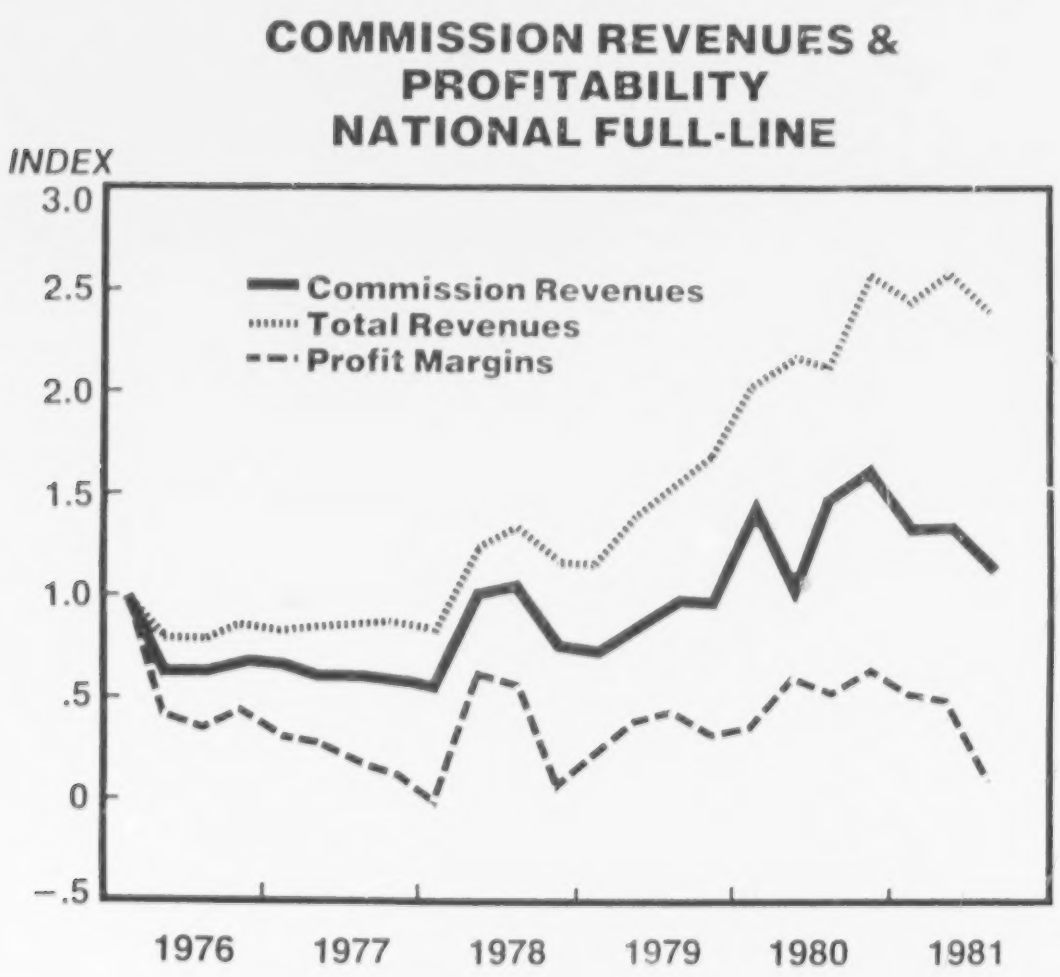


Chart 4

Large Investment Bankers' commission revenues exert much less influence on their profit margins. Commissions are a small segment (12%) of their total business, and their involvement in margin lending is far smaller than that of the National Full Line firms. Trading, however, exerts a greater influence on Large Investment Bankers' profit margins than on those of National Full Line and Regional firms. This is shown in the following graph.

Chart 5

Interestingly, fluctuations in the Large Investment Bankers' underwriting revenues appear very closely related to fluctuations in profit margin, despite underwriting revenues' decline to only 7% of the Large Investment Bankers' 1981 gross revenues. Although National Full Line and Regional firms derive a larger percentage of gross from underwriting, the relationship between underwriting revenues and profit margins is not as close. One possible explanation is that Large Investment Bankers enjoy a disproportionate share of managerships and co-managerships. A likelier explanation lies in the correlation between underwriting and trading. Secondary markets, after all, dictate primary market conditions.

## Trading Breakdown

The various firm categories differ not only in the extent of their trading commitment but also in terms of the securities they trade. It is possible to break trading revenues out into OTC

stock, debt, and "other" trading revenues. The following table reveals very different trading mixes for the National Full Line, Large Investment Banking, and Regional firms. The retail/institutional mix of a firm's customer base determines the firm's trading mix. In this respect, the Regional and Large Investment Banking firms are the ends of a spectrum, with the National Full Line firms somewhere between.

Table 3

Breakdown of Trading Revenues, by Firm Category

1977

| | Debt | OTC | Other | Total | Total ($ Mils.) |
|---|---|---|---|---|---|
| All Firms | 61.6% | 22.5% | 15.9% | 100.0% | $1,057 |
| National Full Line | 51.0 | 32.0 | 17.0 | 100.0 | 406 |
| Large Investment Banking | 82.9 | 9.1 | 8.0 | 100.0 | 375 |
| Regionals | 42.2 | 35.1 | 22.7 | 100.0 | 154 |

1979

| | Debt | OTC | Other | Total | Total ($ Mils.) |
|---|---|---|---|---|---|
| All Firms | 55.0% | 22.3% | 26.0% | 100.0% | $2,157 |
| National Full Line | 55.0 | 28.0 | 17.0 | 100.0 | 883 |
| Large Investment Banking | 66.0 | 7.0 | 27.0 | 100.0 | 801 |
| Regionals | 34.1 | 46.1 | 19.8 | 100.0 | 232 |

1981

| | Debt | OTC | Other | Total | Total ($ Mils.) |
|---|---|---|---|---|---|
| All Firms | 72.7% | 14.3% | 13.0% | 100.0% | $4,241 |
| National Full Line | 74.0 | 22.8 | 3.3 | 100.0 | 1,446 |
| Large Investment Banking | 81.9 | 3.5 | 14.6 | 100.0 | 2,043 |
| Regionals | 44.8 | 38.1 | 17.1 | 100.0 | 420 |

The preponderance of debt in the Large Investment Bankers' trading figures is due partly to an institutional customer base focusing on fixed-income investment. Equally important is the inclusion of accrued interest in trading profits as reported in FOCUS. A bulge in these reported profits can easily conceal a trading loss, since long positions frequently incur a negative

carry. The OTC revenues, in contrast, are relatively "pure," since dividends are not accrued, and cash dividends are negligible for many OTC stocks, anyway. For this group, the "other" trading revenues are more striking in absolute than in relative terms. They reflect the rise of financial futures trading. The growth of these revenues from $39 million in 1978 to nearly $300 million in 1981 explains the Large Investment Bankers' success in weathering the volatile interest rates of the last three years.

For the Regional firms, OTC revenues have at times approached 50% of all trading revenues. They underwent a marked decline in the third quarter of 1981 due to the weak markets then prevailing. Debt trading figures, as noted, are bolstered by accrued interest in bad markets. The National Full Line firms have a far greater involvement in the debt markets than do Regionals. In other respects, their trading mix is somewhat similar.

The primary and secondary markets are closely interrelated, and firms tend to have the same underwriting and trading strengths. This is not surprising, for, in underwriting, distribution, increasingly, is everything. The Regionals' heavy OTC involvement is mirrored in the extent to which they underwrite equity rather than debt securities. Regionals in 1981 had a 25% share of equity underwriting revenues, as compared to a 21% share of total underwriting revenues. This derives partly from the retail nature of the Regionals' customer base, partly from the market risk tolerance that permits small corporations to issue equity sometimes when they cannot issue debt. The Regionals' underwriting market share has followed closely the level of new offerings.

The growing importance of the distribution function at the expense of origination explains too why the national wirehouses' share of underwriting revenues has increased over the past five years, while that of the Large Investment Bankers has declined. The various intergroup mergers that have occurred over the period serve to confirm this trend and in no sense should be used to explain it away. The Large Investment Bankers' greatest underwriting strength is in high-grade corporate debt, of course. It is significant that their market share rose dramatically in the second quarter of 1980. Municipal underwriting is also less of a Large Investment Bankers' activity, due to the tax-exempt status of corporate pension funds and to the presence of commercial banks in the G.O. market.

In the M&A business, distribution strength is secondary to financing expertise and market sense. The Large Investment Bankers' share of Other Related revenues, in which M&A fees are included, has exceeded 40% for most of the past three years. This is well above their underwriting market share, making clear where their strength lies.

Expenses and Profit Margins

The industry's high earnings volatility stems from a mixture of financial and operating leverage. The present analysis, however, raises many questions about industry expenses, both fixed and variable. Is this, indeed, a fixed cost industry? The following two graphs relate changes in gross revenue to changes in profit margin for National Full Line and Large Investment Banking firms. The firms having the most nearly fixed costs, of course, are those that will show increased profit margins as revenues swell. In cases where the profit margin fails to rise with revenues, the firm has incurred expenses at or nearly up to the level of incremental revenues. Large Investment Bankers' and Regionals' profit margins both rise with revenues more closely than do those of the National Full Line firms, which are, therefore, the least fixed-cost of the three groups. For the Large Investment Bankers, trading seems to explain the close relationship between revenues and profit margin. For Regionals, the revenue-profit margin link seems to derive from a closer correlation between the different product lines than is found in the other firm categories; this is a topic calling for further research.

Chart 6

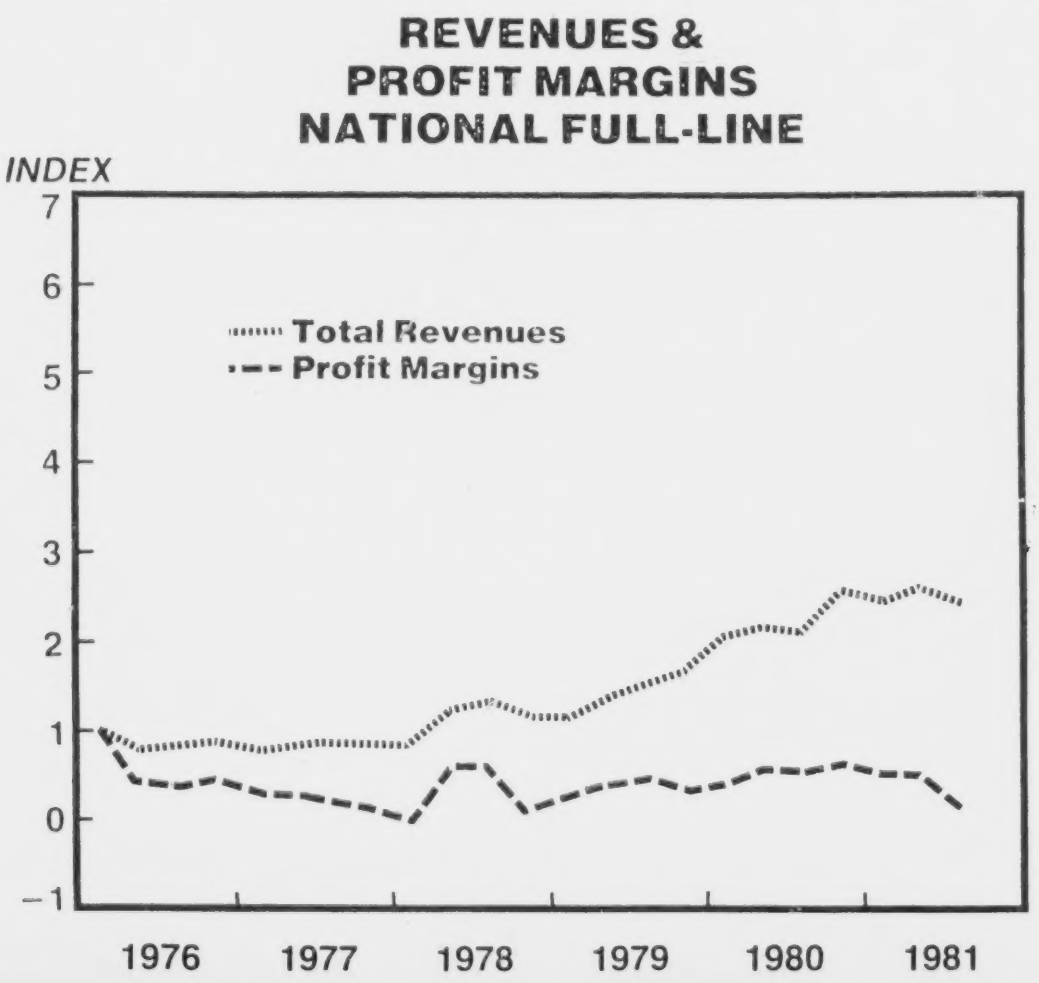
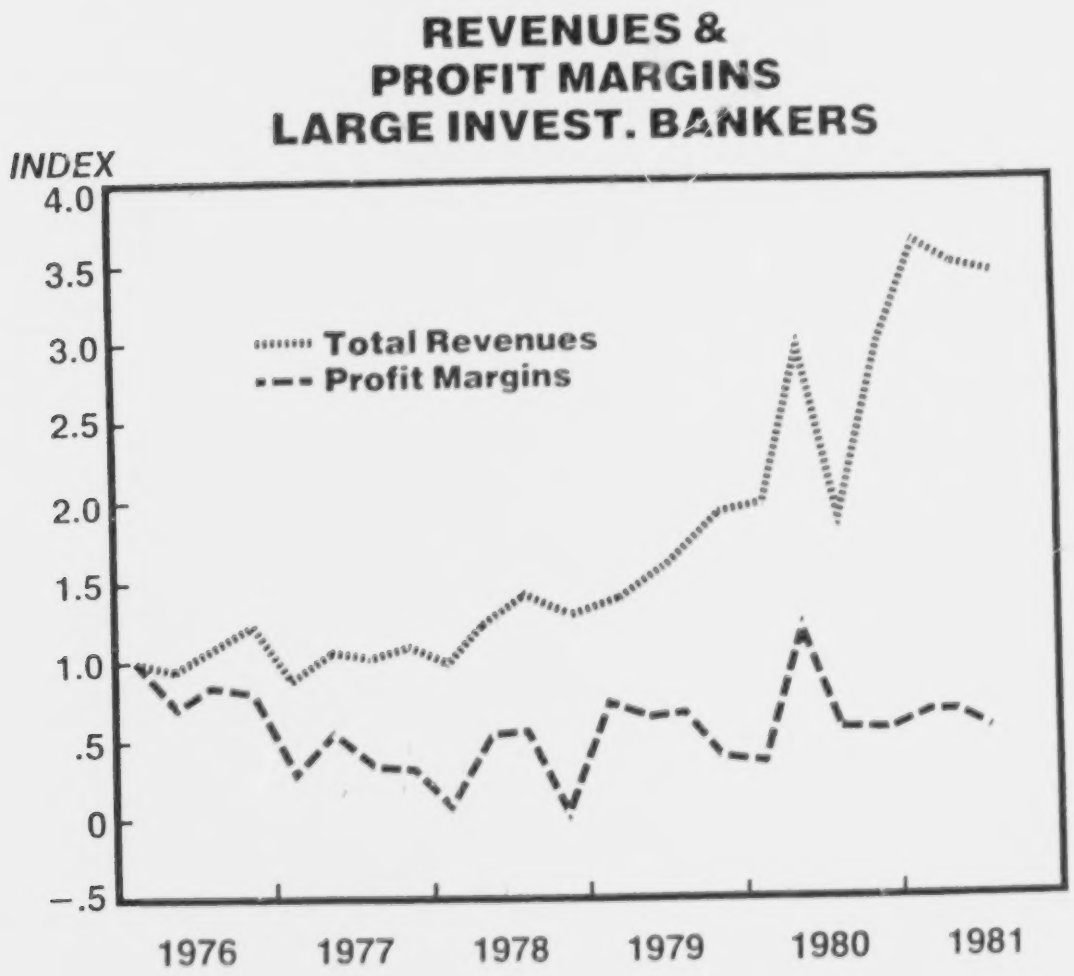
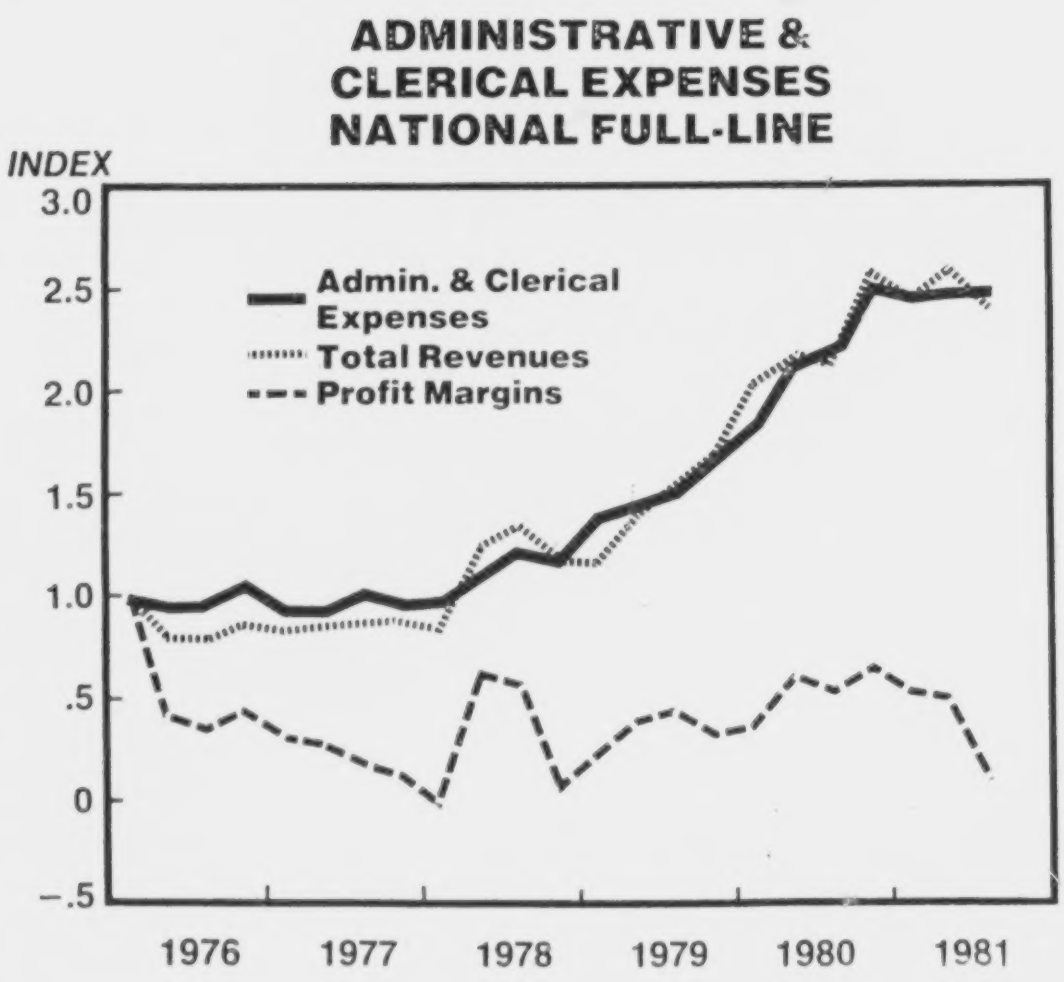


Chart 7




In terms of the FOCUS data, Clerical & Administrative expenses are considered the core of industry overhead. The following three graphs index this expense item to revenues and profit margins for the three groups of firms. Only for Large Investment Bankers does this appear to be a fixed cost, rising much more slowly than revenues and thus buttressing profit margins. For National Full Line and Regional firms, this expense rose nearly at the rate of gross revenues, raising questions about these firms' ability to control overhead. A similar relationship is revealed when Occupancy & Equipment expense is plotted against revenues and profit margins. It is possible that firms are upgrading capacity for the greater level of business expected through the 1980s.

Chart 8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CLERICAL EXPENSES
NATIONAL FULL-LINE
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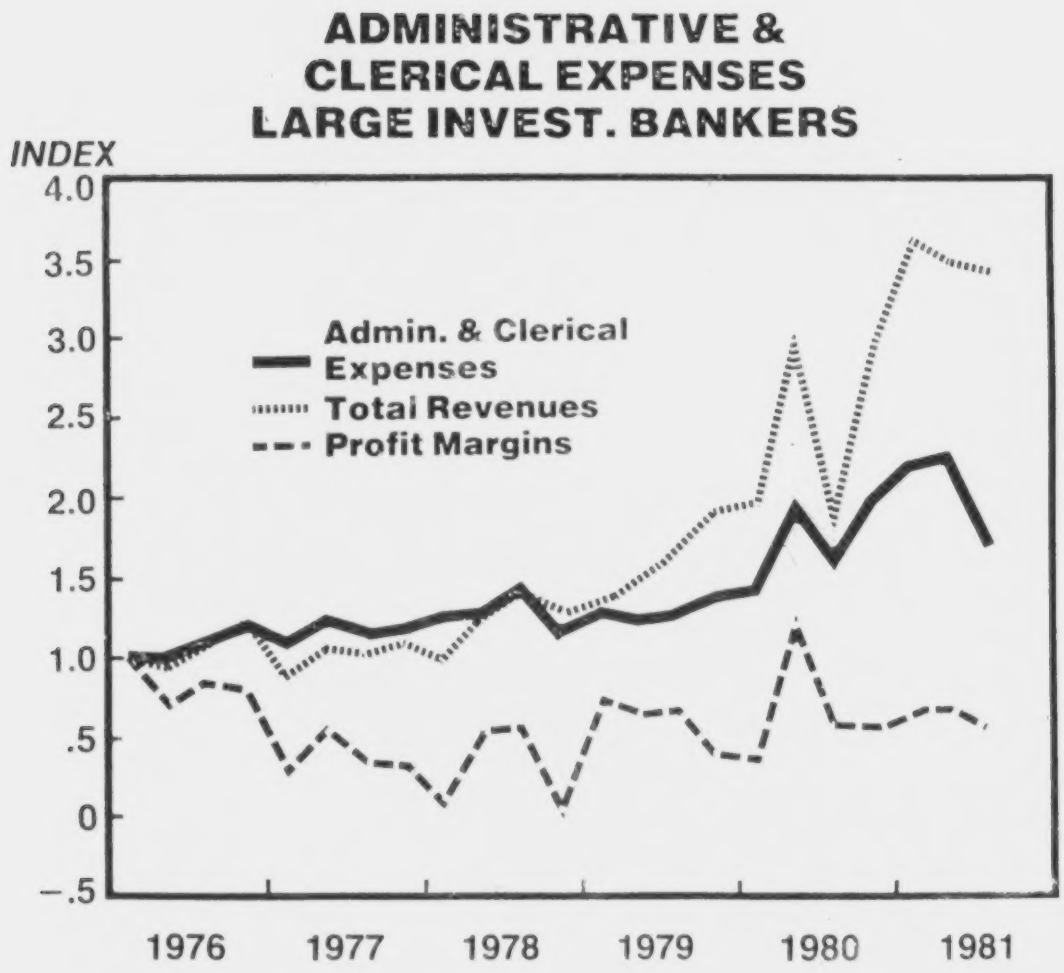
Admin. & Clerical Expenses
Total Revenues
Profit Margins
1976
1977
1978
1979
1980
1981

Chart 9


ADMINISTRATIVE &
CLERICAL EXPENSES
LARGE INVEST. BANKERS
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Admin. & Clerical Expenses
Total Revenues
Profit Margins
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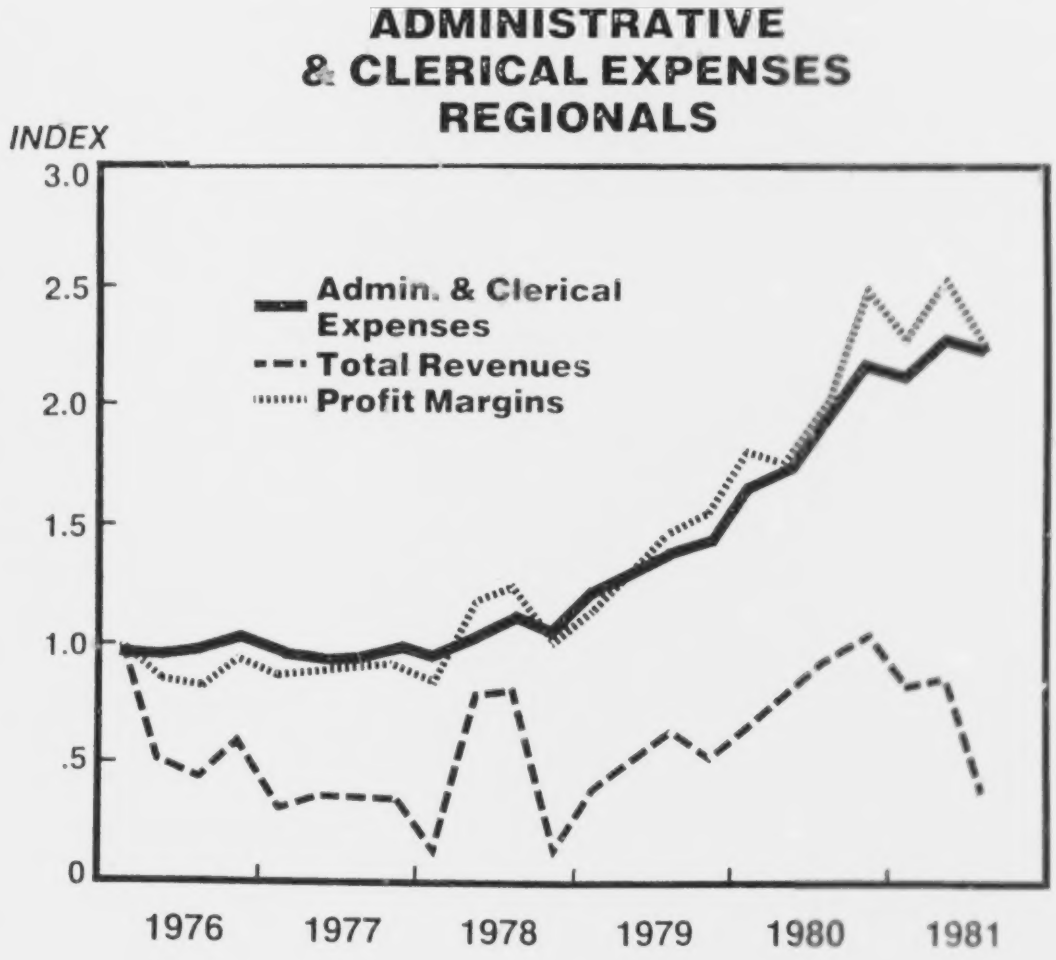
1980
1981

Chart 10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Admin. & Clerical Expenses
Total Revenues
Profit Margins
1976
1977
1978
1979
1980
1981

## Conclusion

This issue represents a first stab at utilizing the data base that is currently being compiled. A not unimportant use to which the data can be put is to examine -- and possibly to discredit -- management notions that have been taken for granted. Among these is the concept of a fixed cost industry. The calculations shown above prove the Large Investment Banking firms to be heavily fixed cost in nature, which explains why their burgeoning fee business should make such an important bottom line contribution. For the Regional firms, however, even the so-called fixed cost items have risen along with revenues over the past three years, a cause for concern in a cyclical industry. By facilitating study of the relationships between net income and individual product lines, this data base can help a firm achieve a better understanding of product profitability. Decisions are shaped not so much by the truth as by what management believes to be the truth. The SIA/DRI data base is designed to help narrow whatever gaps may exist between the two.

Numerous caveats typically surround the launching of any such project. The most basic is that information is only as good -- and as valuable -- as the uses to which it is put. The securities industry data base, as noted, represents a significant enhancement of SIA's own analytic capacities. It is hoped that it can accomplish as much for the readership of this publication.

Jeffrey M. Schaefer
Senior Vice President and
Director of Research

Timothy Y. Smith
Assistant Director of
Research

# SECURITIES INDUSTRY STATISTICS

VOLUME

| | JANUARY 1982 | YEAR-TO-DATE 1982 | JANUARY 1981 | YEAR-TO-DATE 1981 | % CHG. Y-T-D 1982-1981 |
|---|---|---|---|---|---|
| AVERAGE DAILY SHARE VOLUME ON | | | | | |
| NYSE (MILS.)* | 48.4 | 48.4 | 45.5 | 45.5 | 6.4% |
| AMEX (MILS.)* | 4.5 | 4.5 | 6.0 | 6.0 | (25.4) |
| NASDAQ (MILS.)* | 27.8 | 27.8 | 32.8 | 32.8 | (15.2) |
| REGIONAL EXCHANGE (MILS.)* | N.A. | N.A. | N.A. | N.A. | N.A. |
| DOLLAR VALUE OF SHARES TRADED ON | | | | | |
| NYSE (MILS.) | 28,868 | 28,868 | 34,094 | 34,094 | (15.3) |
| AMEX (MILS.) | 1,294 | 1,294 | 2,602 | 2,602 | (50.3) |
| ODD-LOT SHARES PURCHASED ON NYSE (THOUS.) | 5,136 | 5,136 | 5,892 | 5,892 | (12.8) |
| ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.) | 8,801 | 8,801 | 11,469 | 11,469 | (23.3) |
| NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED | 35.4%** | 35.4% | 28.1% | 28.1% | 26.0 |
| CONTRACTS TRADED (THOUS.) | | | | | |
| CBOE OPTIONS | 6,344 | 6,344 | 4,947 | 4,947 | 28.2 |
| AMEX OPTIONS | 3,075 | 3,075 | 2,891 | 2,891 | 6.4 |
| COMMODITY | 7,635 | 7,635 | 8,246 | 8,246 | ( 7.4) |

* Monthly average
** New high

YIELDS
(MONTHLY AVERAGES)

| | JANUARY 1982 | JANUARY 1981 | BASIS POINT CHG. |
|---|---|---|---|
| BOND BUYER INDEX (20 BOND) | 13.28 | 9.66 | 3.62 |
| CORPORATE BOND YIELDS (MOODY'S) | | | |
| Aaa CORPORATE | 15.18 | 12.81 | 2.37 |
| Baa CORPORATE | 17.10 | 15.03 | 2.07 |
| RATIO Aaa CORPORATES TO Baa CORPORATES | 0.89 | 0.85 | 0.04 |
| MUNICIPAL BOND YIELD (MOODY'S) | 12.30 | 8.98 | 3.32 |

PRICES
(END OF MONTH)

| | FEBRUARY 1982 | FEBRUARY 1981 | % CHANGE FEB. '82-FEB. '81 |
|---|---|---|---|
| DOW JONES INDUSTRIALS | 824.39 | 974.58 | (15.4)% |
| STANDARD & POOR'S 500 | 113.11 | 131.27 | (13.8) |
| NYSE COMPOSITE | 65.33 | 75.13 | (13.0) |
| AMEX MARKET VALUE INDEX | 266.13 | 338.94 | (21.5) |
| VALUE LINE COMPOSITE | 127.06 | 144.04 | (11.8) |
| NASDAQ COMPOSITE | 179.43 | 198.01 | (9.4) |

## UNDERWRITING
## (DOLLARS IN MILLIONS)

| CORPORATE FINANCING (Gross New Issues) | DECEMBER 1981 | YEAR-TO-DATE 1981 | DECEMBER 1980 | YEAR-TO-DATE 1980 | % CHANGE DEC. '81-DEC. '80 | % CHANGE YEAR-TO-DATE |
|---|---|---|---|---|---|---|
| Total | 5,908 | 63,300 | 3,983 | 58,178 | 48.3% | 8.8% |
| Competitive | 305 | 4,607 | 295 | 5,724 | 3.4 | (19.5) |
| Negotiated | 5,603 | 58,693 | 3,688 | 52,454 | 51.9 | 11.9 |
| Common Stock | 905 | 15,005 | 1,845 | 13,338 | (46.1) | 12.5 |
| # Of Common Stock Issues | 82 | 937 | 96 | 670 | (14.6) | 39.9 |
| Preferred Stock | 145 | 1,672 | 235 | 3,242 | (38.3) | (48.4) |
| # Of Preferred Stock Issues | 4 | 41 | 5 | 74 | (20.0) | (44.6) |
| Corporate Debt | 4,768 | 46,623 | 1,903 | 41,598 | 150.6 | 12.1 |
| # Of Corporate Debt Issues | 51 | 469 | 26 | 521 | 96.2 | (9.9) |

MUTUAL FUNDS
(DOLLARS IN MILLIONS)

| | DECEMBER 1981 | YEAR-TO-DATE 1981 | DECEMBER 1980 | YEAR-TO-DATE 1980 | % CHANGE, Y-T-D '81 to Y-T-D '80 |
|---|---|---|---|---|---|
| NET SALES* | 118.0 | 1,718.1 | (63.6) | 1,011.6 | 69.8% |
| NET PURCHASE OF COMMON STOCK* | (4.5) | (488.1) | 14.6 | (1,921.1) | 74.6 |
| NET PURCHASE OF OTHER SECURITIES* | 314.1 | 2,082.4 | (22.2) | 2,146.5 | 3.0 |
| MUTUAL FUND CASH POSITION | 12.1 | -- | 9.5 | -- | -- |

*EXCLUDES MONEY MARKET, MUNICIPAL BOND AND OPTION FUNDS

MARGIN DEBT

| | JANUARY 1982 | JANUARY 1981 | % CHANGE JAN. '82-JAN. '81 |
|---|---|---|---|
| MARGIN DEBT OUTSTANDING ($MILS) | 13,090 | 14,020 | (6.6)% |
| NET CHANGE IN MARGIN DEBT ($MILS) | (930) | 2,200 | (142.3) |
| % OF ACCOUNTS WITH EQUITY UNDER 40% | 12% | 14% | -- |

## RECENT INTERESTING READING AND STATISTICAL MATERIAL

| ITEM | DESCRIPTION | SOURCE |
|---|---|---|
| The Future of the Financial Services Industry | This study analyzes the major forces contributing to rapid change and sets forth implications for the structure of the industry, the evolution of markets, business opportunities and public policies. | Order from:<br>Irving Leveson<br>Director of Economic Studies<br>Hudson Institute<br>Quaker Ridge Road<br>Croton-on-Hudson, NY 10520<br>(914) 762-0700<br>Price per copy: $375.00 |
| Competition in the Eighties | Complete transcript of Trends Conference proceedings. Topics include: emerging regulatory/legislative and economic changes, micro and macro determinants of industry profitability, the changing customer base and strategies for the eighties. | Available on a Pre-Paid Basis<br>Order from:<br>Securities Industry Assoc.<br>Research Department<br>20 Broad Street, 19th fl<br>New York, NY 10005<br>Price per copy: $30.00 |
| "What Happens After Glass-Steagall" | Intriguing essay on the shape of the financial services industry in a post-Glass-Steagall era. Author notes some of the snags commercial banks will confront. | Institutional Investor<br>February 1982 |
| "The Art of Persuasion on Capitol Hill" | An account of the deliberations leading up to the Economic Recovery Tax Act of 1981, and the impressive communications and lobbying skills demonstrated by the industry -- more specifically -- registered representatives, their clients and SIA. | Registered Representative<br>January 1982<br>Vol. 6, No. 1 |
| "Deals of the Year" | A ranking of 1981's 50 largest corporate combinations and public financings; includes fees paid to financial intermediaries, in dollars and as a percent of the deal. | Fortune<br>January 25, 1982 |

| ITEM | DESCRIPTION | SOURCE |
|---|---|---|
| Federal Taxes in Historical Perspective | Series of charts depicting trends in federal expenditures and receipts, personal income tax structure, changes in tax provisions affecting capital gains and capital investment, etc. | Office of Economic Research<br>New York Stock Exchange<br>11 Wall Street<br>New York,NY 10005 |
| Public Transaction Study | A comprehensive study of public transactions executed by NYSE member organizations. Provides data on the relative importance of different customer groups, margin activity, foreign activity, geographic distribution,etc. | Business Research Division<br>New York Stock Exchange<br>Eleven Wall Street<br>New York, NY 10005 |
| "Original Issue Deep Discount Bonds" | In-depth discussion of specific features of discount bonds -- tax advantages to borrowers and investors, call protection and reinvestment risk. | Quarterly Review<br>Winter 1981/82<br>Volume 6, No.2<br>Federal Reserve Bank of New York<br>33 Liberty Street<br>New York,NY 10045 |
| "Money Market Mutual Funds and Monetary Control" | Discussion of issues raised by the explosive growth of money market funds (MMFs) viz. the the conduct of monetary policy. Author maintains that, at present, noninstitutional MMF's are held as substitutes for savings rather than transactions accounts. As such, they should continue to be included in M-2. | Quarterly Review<br>Winter 1981/82<br>Volume 6,No.2<br>Federal Reserve Bank of New York<br>33 Liberty Street<br>New York, New York 10045 |

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# SUPPLY-SIDE ECONOMICS IN ACTION: THE IMPACT OF LOWER CAPITAL GAINS TAXES

## HIGHLIGHTS

1. The effectiveness of the capital gains tax cut of 1978, a directly targeted supply-side measure, and the results of the SIA/Opinion Research Corporation study Executives' Investment Responses to Changing the Holding Period for Tax Treatment of Capital Gains provide strong impetus for a critical examination of the one-year holding period.

2. Several significant indicators discussed in this paper document the success of the 1978 capital gains tax cut in stimulating certain sectors of the economy. Most importantly, preliminary IRS data for 1980 show that sales of capital assets in 1980 were at virtually the same heightened level as 1979. While it is generally agreed that the capital gains tax cut led to increased revenues in 1979, the newly released data suggest that the cut also led to increased revenues in 1980.

3. Over half the surveyed executives in the study said they would increase investment in one or more of eleven investment vehicles during the first year a six-month holding period was in effect. In terms of investment vehicles, common stocks were by far the most popular, chosen by almost 40% of those indicating additional or new purchases.

4. During the past two years, nearly one-third -- 31% -- of the executives reported assets they planned to sell declined in value because of changing market conditions in the second six months of ownership. The average decline due to holding assets for at least one year to qualify for long-term capital gains tax treatment was $15,714. This may have translated into Treasury revenue losses of $470-$590 million.

5. Assuming that 10% of all individuals in the same income class as the surveyed executives would follow similar investment behavior, total new and increased investment would be around $50 billion during the first year of a reduced holding period, or 7.5% of the increase in personal financial holdings from 1979-80.

## Introduction

In recent months supply-side economics, the basis for the Economic Recovery Tax Act of 1981, has become the subject of controversy and debate. Within less than nine months, critics have labeled the 1981 tax package a failure and supply-side economics a theory to be forgotten. However, before the 1981 policy measures fall into complete disrepute, both the current economic environment and the thrust of the policy measures should be brought into perspective.

In 1981 and 1982, the stated concern of monetary policy has been to bring down the extraordinary rate of inflation that has plagued the U.S. in recent years. A measure of success can be claimed as the rate of inflation has subsided from 12.4% in 1980 to 8.9% in 1981. Nevertheless, restrictive monetary policy has fostered high interest rates that have cost dearly in terms of economic growth and have blunted the effectiveness of fiscal measures aimed at slowing increases in government spending and lowering taxes as a percentage of national income.

Individual tax cuts in the 1981 tax act mainly addressed increasing after-tax income. Hopefully, additional after-tax income would encourage individuals to work harder, with savings rather than consumption emphasized. While supply-side in orientation, policy measures aimed at wage income are not as efficient at stimulating savings and investment as directly targeted measures. For one thing, most individuals are limited to some extent in the amount of additional hours that can be worked, even if each hour generates more income than before. In contrast, the option to save or consume is very flexible and there are numerous investment vehicles to channel additional savings to. The capital gains tax cut in 1978, a change aimed at alleviating the tax burden on investment, is a prime example of the stimulatory impact of a directly targeted supply-side measure.

SIA strongly believes that tax policy must continue to focus on the crucial link between savings and investment and economic growth. The results of a recent SIA research report[1/] indicate that a reduction or elimination of the one-year capital gains holding period would unleash a considerable amount of new and additional investment. A reduction in the holding period to six months would represent the restoration of policy that was in effect from

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1/ Copies of the 20-page report Executives' Investment Responses to Changing the Holding Period for Tax Treatment of Capital Gains are available from SIA's Research Department at a price of $3 per copy.

the early 1940's through 1976.[2/] It is interesting that the one-year holding period became effective in 1976 primarily as a trade-off to an increase in the capital loss provision against ordinary income. In 1975-76, the proposal to increase the capital loss offset from $1,000 to $3,000 gathered considerable momentum. However, some liberal Congressmen argued that there must be an offset to this provision. Interestingly, one of the leading opponents to extending the holding period from six months to one year was Congressman Rostenkowski, now the powerful chairman of the House Ways and Means Committee.

The effectiveness of the 1978 capital gains tax cut and the results of the SIA research report, as highlighted in this paper, provide strong impetus for a critical examination of the current capital gains holding period. Given the current recession and need for capital investment, the U.S. can ill-afford policy measures that hinder savings and investment.

## Update on the Experience with the Capital Gains Tax Cut in 1978

Several significant trends document the success of the 1978 capital gains tax cut in stimulating certain sectors of the economy. These trends substantiate our position that removal of tax disincentives on investment will encourage investment and savings. Little dispute remains as to the effectiveness of this tax cut.

### Stock Market Indices

During the 1970's, equity investment lost its position as the traditional hedge against inflation to tangible investments, such as real estate, metals and art. Yet, in 1979 and 1980, years marked by double-digit inflation, record high and volatile interest rates, and deteriorating financial positions of many corporations, the stock market indices recorded significant gains. In 1981, the advances of the NYSE and S&P 500 indices were halted by the end of the first quarter, and both the AMEX and NASDAQ indices peaked in May. A host of uncertainties intensified as 1981 progressed including the continued climb of interest rates, the implications of the new Administration's fiscal policies for the deficit, and the drop into recession. Nevertheless, the 3.2% decline registered by the NASDAQ index, which reflects values of the nation's smaller and newer companies, is considerably smaller than the fall off of the indices reflecting stock prices of larger companies.

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2/ The Administration's Economic Recovery Tax Act of 1981 included a proposal to reestablish the six-month holding period until the final stages of the bill's passage. However, no hearings were held on the six-month holding period in the House or Senate earlier in the year, and the proposal fell victim to political compromise.

Overall, from year-end 1978 to year-end 1981, the increases in the AMEX and NASDAQ indices are impressive, 113% and 66%, respectively. These indices represent the smaller capitalized companies, the ones the individual investor usually focuses his attention on in the hopes of realizing capital gains through above-average price appreciation. In contrast, the indices representing the larger companies enjoyed a gain of less than one-half as much in the same time frame.

Table 1

Percentage Increase in Stock Market Indices

| Period | S&P 500 Index | NYSE Common Stock Index | AMEX Market Value Index | NASDAQ Index |
|---|---|---|---|---|
| 12/78 - 12/79 | 12.3% | 15.5% | 64.1% | 28.1% |
| 12/79 - 12/80 | 25.8 | 25.7 | 41.3 | 33.9 |
| 12/80 - 12/81 | (9.7) | (8.7) | (8.1) | (3.2) |
| 12/78 - 12/81 | 27.5 | 32.6 | 113.0 | 66.0 |

Companies Going Public

The increased value placed on the stocks of smaller companies has created a market climate conducive to the initial public offerings of new and emerging companies, which create a disproportionate number of new jobs. From 1969 to 1975, following increased capital gains taxes, the number of companies going public plunged a dramatic 99%, with a scant 15 new companies raising capital in 1975. In the first half of 1978, only 16 companies went public, raising a meager $64.2 million. However, in the second half of the year when passage of the Revenue Act of 1978 was imminent, 29 companies raised almost three times the capital raised in the first six months of 1978.

While both the number of companies going public and the new capital raised in 1979 nearly doubled from the 1978 level, the 1980 and 1981 results are more striking still. In 1980, 237 companies raised $1.4 billion in new capital. In 1981, 448 companies came to market, representing the third highest number of issues in the 1969-81 period. A record-setting $3.2 billion was raised by these companies.

Table 2

Companies Going Public

| | 1969 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 |
|---|---|---|---|---|---|---|---|---|
| Number of Issues | 1,026 | 15 | 34 | 40 | 46 | 81 | 237 | 448 |
| Share Value ($mils.) | $2,605 | $265 | $234 | $153 | $250 | $506 | $1,397 | $3,215 |

Source: Going Public

Venture Capital

New capital raised by venture capital firms averaged $54.5 million annually in the 1970-77 period, reaching a peak of $97 million in 1970 and a low of $10 million in 1975. Only $39 million was raised in 1977, but in 1978 the figure soared to $570 million. After dipping to $319 million in 1979, still substantially above the annual average, new capital raised by venture capital firms jumped to $900 million in 1980. Moreover, 1981 is estimated at $1.3 billion, more than 13 times the 1970 figure.

Shareownership

Individual shareownership, as reported in the NYSE's Shareholder Census, has risen and fallen in concert with tax policy changes on investment in recent years. While many factors influence an individual's investment decisions, the after-tax return on investment is of prime importance. Between 1970 and 1975, the number of people owning shares fell 18%, as the 1969 capital gains tax reduced returns on equity investments. However, individual shareownership rose to 30.2 million between 1975 and 1980, almost completely recovering the loss of the prior five years. Moreover, the 2.1 million gain in shareholders from mid-1980 to mid-1981 pushed shareownership to a record 32.3 million, thus surpassing the 1970 record by almost 1.5 million individuals.

Increases in new shareownership, those purchasing stock for the first time, demonstrates even more convincingly the potentially stimulatory effects of tax policy on investment. Between 1965-70, 5.3 million new shareowners were reported, while only 2.2 million individuals purchased equity for the first time in the 1970-75 period. However, from 1975 through 1980, this figure rose to 6.5 million. During 1980-81 alone, a significant 2.4 million new shareholders were reported.

A closer look at yearly patterns is revealing. From 1/1/75 to 12/31/78 -- a period during which the maximum capital gains tax rate increased to about 50% -- the shareowner population rose by a monthly average of 87,000. Between the 1½-year period 1/79-6/80, the number of new shareowners rose 51% to an average monthly increase of 130,000. The pace in the latest measured period, 1980-81, is an average of nearly 200,000 individuals per month.

Treasury Revenues

Prior to the capital gains tax cut in 1978, opponents of the cut argued two main points. First, capital gains tax revenues would decline because of the lower tax rates and, second, if there were a spurt in capital gains realized from 1978 to 1979, this would be a one-time phenomenon, with gains drifting to lower levels by 1980. There was a 15.4% spurt in capital gains realized from 1978 to 1979, but gains have not subsided from the increased level. Preliminary IRS data for 1980 show that the sales of capital assets

in 1980 were virtually the same as in 1979. Most observers agree that the cut in capital gains taxes actually led to increased revenues in 1979. The newly released data suggest that the cut most likely led to increased revenues in 1980 as well. In other words, capital gains tax revenues in 1979 and 1980 exceeded those projected by Treasury for those years before passage of the Revenue Act of 1978.

Those who dispute the theory that the 1978 tax cut has induced a long-term effect on the level of capital gains realizations point to 1980 data as evidence. In a recent publication,3/ one observer who questions the effectiveness of the cut focuses on net long-term gains in excess of short-term capital losses. While preliminary data indicate that net long-term gains in excess of short-term loss dipped to $63.4 billion in 1980 from $69.7 billion in 1979, the 1980 figure is still 30% above the 1978 level. The observer notes the inclusion in 1979 gains of the Belridge Oil merger, $3.65 billion, clearly an unusually large capital gains transaction. Given the absence of such a transaction in 1980, the level of gains is significant. More importantly, a crucial issue is overlooked by critics -- how actual capital gains tax revenues in 1979 and 1980 compare with Treasury projections for those years before the Revenue Act of 1978 became effective.

## Highlights of the Survey

The securities industry was effective in urging the Congress to restore long-term capital gains taxes in the direction of what they were before 1969 with passage of the Revenue Act of 1978. We believe the experience since then supports that decision. The industry also believes that it would be sound economic policy to restore the holding period to what it was prior to 1976. Indeed, the holding period had remained unchanged at six months from 1942-76 and had served the equity markets well.

To determine how investors would react to a change in the holding period, SIA commissioned Opinion Research Corporation4/ to conduct a survey among executives to answer several questions concerning the holding period and capital gains. By assessing the attitudes and preferences of the executive community, it is

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3/ Joseph Minarik, "Letters to the Editor," Tax Notes, 4/5/82.

4/ The ORC quarterly Executive Survey is sponsored by multiple clients and is conducted via personal interviews among a sample of top and middle managers in the "Fortune 800" companies. For SIA's survey, interviews were conducted with 568 individuals in October-November 1981. Respondents were not told that their responses were being studied by SIA.

possible to make judgments, although not precise predictions, about the overall impact of any proposal on the investing public. Of particular note, there is a marked consistency of executive opinion on the capital gains holding period, as evidenced in comparing the recent survey with a similar one conducted in 1979 by ORC for SIA. The results of the March 1982 survey, Executives' Investment Responses to Changing the Holding Period for Tax Treatment of Capital Gains, are highlighted in the following sections.

Impact of a Reduced Holding Period

> "If the capital gains holding period were reduced from one year to six months, would it cause you to make new investments, or increase existing investments, in any of the eleven items listed? If so, by approximately how much would you make new or increased investments in any particular asset during the first year?"

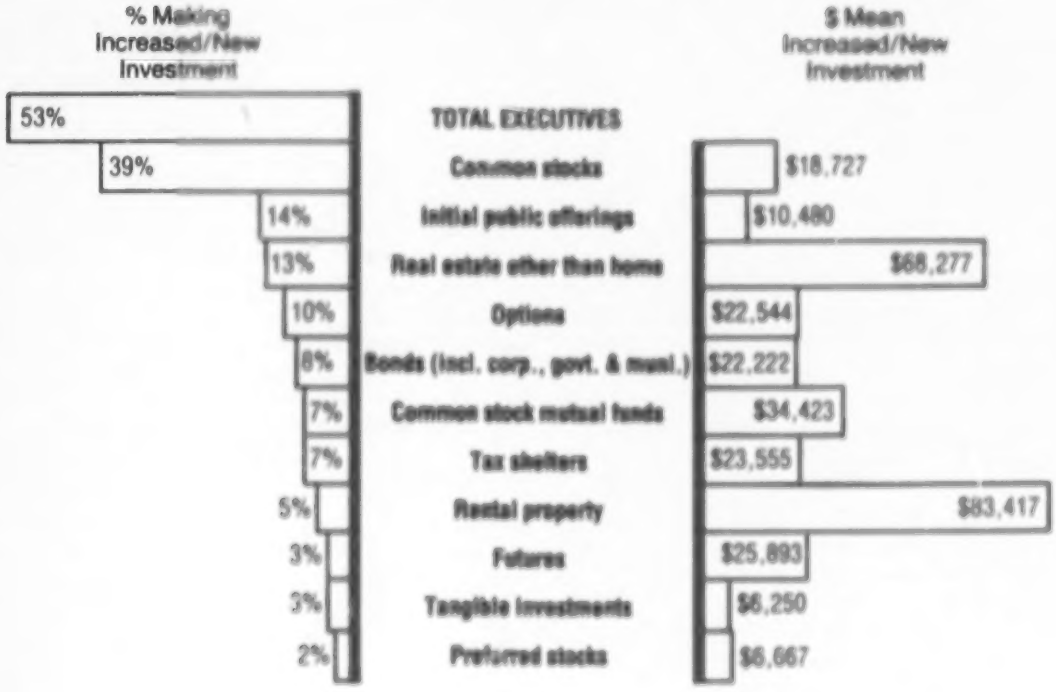
As shown in Chart I, over half the survey respondents -- 53% -- indicated that they would make new investments or increase existing investments in one or more of eleven investment vehicles if the holding period were reduced to six months. Common stocks was by far the most popular asset choice, chosen by nearly 4 in 10 of the executives responding positively. The mean investment generated in seasoned common equities was almost $19,000. As the second most popular asset choice, initial public offerings was earmarked for new investment by 14% of the executives. The mean value of the new investment in IPOs was $10,500.

Given the rapid escalation of housing prices in the 1970's, it is not surprising that some investors found real estate an attractive vehicle for increased investment. Of the eleven investments listed, the mean amount that would be invested by those who responded positively was greatest in rental property and real estate other than home. Most investment in real estate necessarily requires a substantial commitment of capital. In terms of percentage response, real estate other than home ranked third, following common stocks and initial public offerings.

Although slightly less than 10% of the executives responding positively chose bonds, the mean value of projected investment was $22,200, a larger dollar mean than projected in common stocks or IPOs. This larger figure may be attributable to the fact that most debt offerings are in denominations of at least $1,000, a considerably higher sum than the price of equity issues.

Chart I

**EXECUTIVE REACTIONS TO A SIX-MONTH HOLDING PERIOD DURING THE FIRST YEAR**




Executives were asked to quantify the amount of their new investment during the first year of a six-month holding period. Almost one-third of those who chose common stock for increased investment indicated that their new investment constituted 50% or more over what they would invest under the present holding period. In the case of IPOs, the percentage increase indicates a six-month holding period would have an even more significant effect. Of the 14% choosing IPOs, almost 40% would increase their commitments by 50% or more. From these indications, a reduced holding period could be expected to stimulate a significant amount of investment in both seasoned equities and IPOs, thereby lowering the cost of sorely needed equity capital for U.S. companies.

Summing up, the increased investment that would be generated by a six-month holding period represents substantial increments over what would be invested under the one-year holding period. Of those who would increase their investment in one or more of the eleven investment vehicles, about 31% indicated the new investment constituted 50% or more than they would invest under the present holding period. In total, 66% estimated the incremental investment at over 20%, while the remainder reported the increment was under 20% of what they would invest. The data suggest that investment plans would be upscaled considerably if a six-month holding period took effect.

Losses Due to the One-Year Holding Period

"During the past two years, have you experienced any cases where potential gains in investments, such as common stocks, that you owned and were planning to sell for long-term capital gains, either shrank or turned into losses because of changing market conditions during the period between six months and one year of holding them? What was the total amount of these lost gains?"

About 31%, or 177 of the 568 executives, indicated declines in the value of assets during the second six months of ownership that they planned to sell for long-term capital gains. Among the 31% of executives reporting "disappearing" gains, the mean loss generated because of changing market conditions was $15,714. Lost potential capital gains translate to lost potential Treasury revenues. If individuals have experienced diminishing gains or losses of potential gains during six months to one year of retaining their assets, the Treasury has obtained less revenue than if these individuals were to realize gains in a shorter time span.

The average income of the executives experiencing reduced gains or losses was $70,000. If only 10% of individuals filing returns in the $50,000-$100,000 AGI class in 1978 experienced a similar trend in capital gains, the total potential loss would be about $2.4 billion. Assuming the tax rate on capital gains for individuals in this income group in 1978 fell between 20%-25%, the estimated Treasury revenue loss ranges between $470-$590 million. This is in striking contrast to the $350 million "static" gain estimated to be gained by Treasury from lengthening the holding period from six months to one year.

Under a six-month holding period, investors could realize capital gains before they diminish or turn to losses. The increased realization potential, we believe, offsets the estimated revenue loss due to taxing gains in the six-month to one-year time frame at capital gains rates rather than ordinary tax rates. A recent major study5/ and preliminary IRS 1977 data on holding periods show that short-term gains yield little taxes because, in general, individuals realize short-term gains only when they can be offset by losses.

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5/ Steve Kaplan, The Holding Period Distinction of the Capital Gains Tax, National Bureau of Economic Research, Inc., Working Paper No. 762, 9/81.

Impact of Elimination of the Holding Period

> "If the capital gains holding period were eliminated, would it cause you to make new investments, or increase existing investments, in any of the eleven items listed? If so, by approximately how much would you make new or increased investments in any particular asset during the first year?"

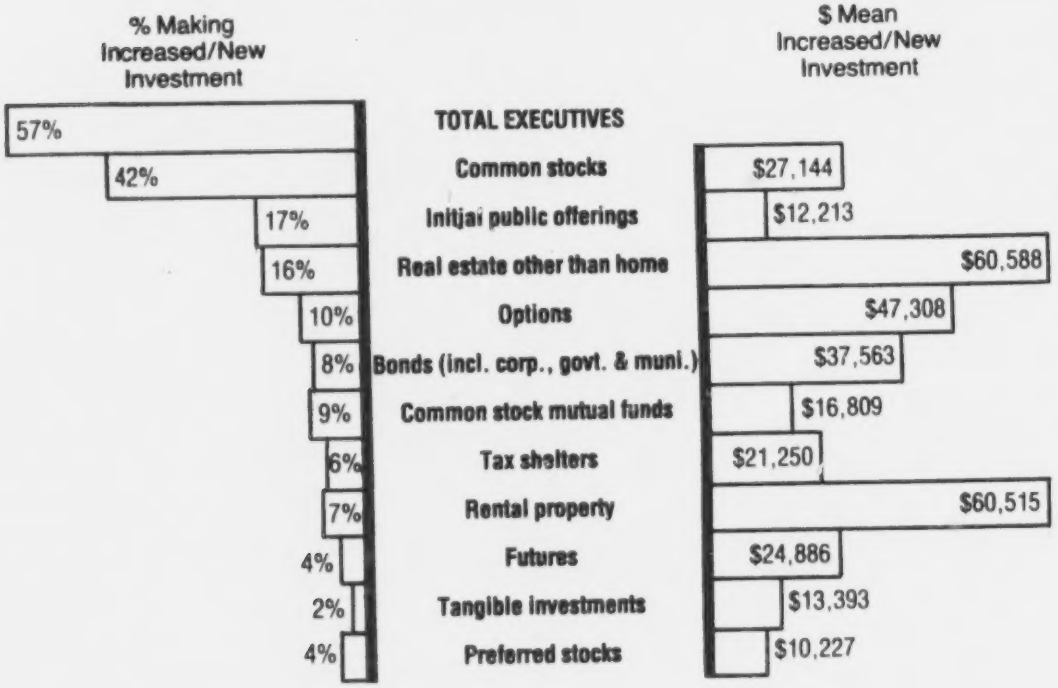
Well over half -- 57% -- of the executives indicated that they would make new or increase existing investments if the holding period were reduced to six months. As under a reduction to six months, common stocks were the most favored investment, chosen by 42% of the executives. The mean investment generated was $27,100, about 45% higher than the mean produced by a reduced holding period. IPOs were the next investment vehicle in importance, selected by 17% of the executives and generating a $12,200 mean. Real estate other than home again ranked third in terms of percentage response. In addition, the mean dollar generated by increased investment in real estate was again the largest.

Particularly in the case of bonds, more investment would be elicited by an elimination of the holding period rather than a reduction. While the percentage of executives indicating new investment in bonds is 8% under both proposals, executives indicated a $37,600 average commitment under elimination compared with $22,200 under a reduction. Reflecting the unprecedented volatility of the debt markets in recent years, risk is now even associated with bond investment, a once traditionally safe and liquid asset. Given the reluctance of investors to commit funds to the long-term debt market in recent years, the holding period is an important consideration.

Generally, the responses to the complete elimination of the holding period are similar to those for a reduction. For almost all investment vehicles, the percentage of executives willing to invest as well as the mean investment increased with complete elimination of the holding period.

Chart II

**EXECUTIVE REACTIONS TO ELIMINATION OF THE HOLDING PERIOD DURING THE FIRST YEAR**




## Comparison of Reduction and Elimination of the Holding Period

Based only on responses in this survey, the total new/increased investment generated by a reduction or elimination of the holding period is impressive. With a six-month holding period, new common stock investment during the first year amounted to a significant $4.1 million, second only to the $5.0 million of new funds flowing to real estate. Rental property drew the third largest flow of new funds, followed by options at $1.3 million.

Compared to a six-month holding period, an elimination of the holding period produced higher total investment in eight of the eleven investment vehicles. Common stock investment jumped 56% to become the most favored investment vehicle, with total potential new funds at $6.5 million. Real estate other than home fell to second place, with new investment under the elimination increasing minimally from the six-month total. Investment in rental property also increased slightly. Initial public offerings benefitted notably under an elimination proposal, increasing over 40% from $833 thousand to $1.2 million.

Table 3

Total New/Increased Investment Generated During the First Year of a Change in the Holding Period
($ Millions)

| Reduction | | Elimination |
|---|---|---|
| $4.2 | Common stocks | $6.5 |
| 0.8 | Initial public offerings | 1.2 |
| 5.0 | Real estate other than home | 5.5 |
| 1.3 | Options | 2.7 |
| 1.0 | Bonds (incl. corp., govt. & muni.) | 1.7 |
| 1.4 | Common stock mutual funds | 0.9 |
| 0.9 | Tax shelters | 0.7 |
| 2.4 | Rental property | 2.4 |
| 0.4 | Futures | 0.6 |
| 1.1 | Tangible investments | 0.2 |
| 0.1 | Preferred stocks | 0.2 |

Assuming that 10% of the individuals filing tax returns in 1978 in the same income class as the executives surveyed have similar investment responses, the amount of new investment is substantial. During the first year of a change in the holding period, the amount of total investment would be around $50 billion. The increased funds flowing to common stocks alone would be about $2.8 billion under a reduced holding period and almost $4 billion with an elimination. IPOs would also benefit significantly, with new investment running a shade below $2 billion. While these aggregate flows seem staggering, in the context of total financial assets of households they are quite plausible. The estimated $50 billion of new investment represents about 7.5% of the annual increase of financial holdings of households from 1979-80.

## International Treatment of Capital Gains

In late 1980, Arthur Andersen released results of a study commissioned by SIA on the international tax treatment of capital gains on portfolio investment. Of the ten major foreign countries reviewed, seven do not distinguish between long- and short-term gain. Germany requires a six-month holding period for long-term capital gains, while Australia has the same holding period requirement as the U.S. Only one country, Sweden, has a longer holding period than the U.S.

The Economic Recovery Tax Act of 1981 was a welcomed step in easing the tax burden on capital gains. However, the U.S. still lags most foreign countries in encouraging savings and investment. Among the ten foreign countries covered in the study, four do not tax capital gains income at all and both Australia and Germany exempt long-term gain. In terms of the maximum tax on short-term gain, the U.S. rate remains among the highest.

Table 4

Minimum Holding Period to Qualify
for Long-Term Gain Treatment

| None | Six Months | One Year | Two Years |
|---|---|---|---|
| Belgium | Germany | Australia | Sweden |
| Canada | | U.S. | |
| France | | | |
| Italy | | | |
| Japan | | | |
| Netherlands | | | |
| United Kingdom | | | |

## Conclusion

Both the successfulness of the 1978 capital gains tax cut and the recent SIA/ORC research report on the capital gains holding period present strong evidence that the targeted removal of tax disincentives on savings will have a favorable impact on capital formation. The debate over the one-year holding period has intensified in recent years, given the increased volatility of the capital markets. Individuals involved with the securities markets as issuers, investors or intermediaries believe that a one-year holding period is a major impediment to investment, limiting the aggregate flow of funds into the U.S. capital markets at a time when such investment is sorely needed and reducing the market's ability to allocate capital efficiently. We believe the time has come to restore the holding period requirement to what it was prior to 1976. Such a tax change would stimulate investment and increase, not decrease, tax revenues.

Jeffrey M. Schaefer
Senior Vice President and
Director of Research

Carolyn Hildebrandt
Associate Director
of Research

# SECURITIES INDUSTRY STATISTICS

VOLUME

| | FEBRUARY 1982 | YEAR-TO-DATE 1982 | FEBRUARY 1981 | YEAR-TO-DATE 1981 | % CHG. Y-T-D 1982-1981 |
|---|---|---|---|---|---|
| AVERAGE DAILY SHARE VOLUME ON | | | | | |
| NYSE (MILS.)* | 51.2 | 49.8 | 43.0 | 44.3 | 12.4% |
| AMEX (MILS.)* | 4.4 | 4.5 | 4.8 | 5.4 | (16.7) |
| NASDAQ (MILS.)* | 27.7 | 27.8 | 28.7 | 30.8 | (9.7) |
| REGIONAL EXCHANGE (MILS.)* | 7.2 | 6.9 | 5.3 | 5.4 | 27.8 |
| DOLLAR VALUE OF SHARES TRADED ON | | | | | |
| NYSE (MILS.) | 28,260 | 57,128 | 27,925 | 62,019 | (7.9) |
| AMEX (MILS.) | 1,253 | 2,547 | 1,764 | 4,366 | (41.7) |
| ODD-LOT SHARES PURCHASED ON NYSE (THOUS.) | 4,292 | 9,428 | 4,652 | 10,544 | (10.6) |
| ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.) | 8,669 | 17,470 | 10,037 | 21,506 | (18.8) |
| NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED | 36.7%** | 36.1% | 30.6% | 29.4% | 22.8 |
| CONTRACTS TRADED (THOUS.) | | | | | |
| CBOE OPTIONS | 5,085 | 11,429 | 3,920 | 8,867 | 28.9 |
| AMEX OPTIONS | 2,645 | 5,720 | 2,180 | 5,071 | 12.8 |
| COMMODITY | 7,763 | 15,398 | 7,303 | 15,549 | (1.0) |

* Monthly average
** New high

## YIELDS

(MONTHLY AVERAGES)

| | March 1982 | March 1981 | Basis Point Chg. |
|---|---|---|---|
| BOND BUYER INDEX (20 BOND) | 12.82 | 10.16 | 2.66 |
| CORPORATE BOND YIELDS (MOODY'S) | | | |
| Aaa CORPORATE | 14.58 | 13.33 | 1.25 |
| Baa CORPORATE | 16.82 | 15.34 | 1.48 |
| RATIO Aaa CORPS. TO Baa CORPS. | | | |
| MUNICIPAL BOND YIELDS (MOODY'S) | 11.95 | 9.50 | 2.45 |

## PRICES

(END OF MONTH)

| | April 1982 | April 1981 | % Change Yr.-to-Yr. |
|---|---|---|---|
| DOW JONES INDUSTRIALS | 822.77 | 1014.14 | (18.9)% |
| STANDARD & POOR'S 500 | 111.96 | 136.57 | (18.0) |
| NYSE COMPOSITE | 64.52 | 78.62 | (17.9) |
| AMEX MARKET VALUE INDEX | 260.12 | 368.89 | (29.5) |
| VALUE LINE COMPOSITE | 125.31 | 154.93 | (19.1) |
| NASDAQ COMPOSITE | 175.65 | 211.34 | (16.9) |

UNDERWRITING
(DOLLARS IN MILLIONS)

MUNICIPAL FINANCING*
(Gross New Issues)

| | March 1982 | Y-T-D 1982 | March 1981 | Y-T-D 1981 | % Change Mar. '82 to Mar. '81 | % Change Yr.-to-Date |
|---|---|---|---|---|---|---|
| Total | 8,151 | 20,641 | 5,413 | 14,857 | 50.6% | 38.9 |
| Notes | 2,774 | 8,007 | 1,718 | 5,698 | 61.5 | 40.5 |
| Bonds | 5,377 | 12,634 | 3,695 | 9,159 | 45.5 | 37.9 |
| # of Bond Issues | 311 | 953 | 400 | 838 | (22.3) | 13.7 |
| Negotiated Bonds | 3,420 | 8,400 | 1,810 | 4,930 | 89.0 | 70.4 |
| Revenue Bonds | 3,350 | 8,200 | 2,120 | 5,790 | 58.0 | 41.6 |

*Preliminary Figures

MUTUAL FUNDS
(DOLLARS IN MILLIONS)

| | February 1982 | Year-To-Date 1982 | February 1981 | Year-To-Date 1981 | % Change, Y-T-D '82 to Y-T-D '81 |
|---|---|---|---|---|---|
| NET SALES* | 267.8 | 652.6 | 108.0 | 341.0 | 91.4 |
| NET PURCHASE OF COMMON STOCK* | 122.2 | (790.8) | 50.4 | 233.3 | (439.0) |
| NET PURCHASE OF OTHER SECURITIES* | 301.6 | 247.6 | 21.5 | 156.2 | 58.5 |
| MUTUAL FUND CASH POSITION | 11.8 | ---- | 9.5 | ----- | ----- |

*EXCLUDES MONEY MARKET, MUNICIPAL BOND AND OPTION FUNDS

MARGIN DEBT

| | February 1982 | February 1981 | % Change Feb.'82-Feb.'81 |
|---|---|---|---|
| MARGIN DEBT OUTSTANDING ($MILS) | 12,770 | 13,950 | (8.5)% |
| NET CHANGE IN MARGIN DEBT ($MILS) | (1,180) | 1,490 | (179.2)% |
| % OF ACCOUNTS WITH EQUITY UNDER 40% | 13% | 14% | ---- |

## FINANCIAL DATA FOR NYSE FIRMS DOING A PUBLIC BUSINESS
## (MILLIONS OF DOLLARS)

| | Fourth Quarter 1981 | Yr.-to-Date 1981 | Fourth Quarter 1980 | Yr.-to-Date 1980 | % Change 4th Q.1981 4th Q.1980 | % Change Yr.-to-Date 1980 |
|---|---|---|---|---|---|---|
| REVENUE | | | | | | |
| SECURITIES COMMISSION INCOME | 1,268 | 5,346 | 1,682 | 5,671 | (24.6)% | (5.7)% |
| REALIZED AND UNREALIZED GAIN OR LOSS IN TRADING AND INVESTMENT | 1,563 | 4,813 | 1,038 | 3,699 | 50.6 | 30.1 |
| PROFIT OR LOSS FROM UNDERWRITING AND SELLING GROUPS | 405 | 1,572 | 409 | 1,307 | (1.0) | 20.3 |
| TOTAL REVENUE | 5,449 | 19,805 | 4,774 | 15,986 | 14.1 | 23.9 |
| TOTAL EXPENSES | 4,831 | 17,666 | 4,076 | 13,721 | 18.5 | 28.8 |
| NET INCOME BEFORE TAXES | 618 | 2,139 | 698 | 2,265 | (11.5) | (5.6) |
| PERCENT OF FIRMS SHOWING LOSS | 105 | ---- | 54 | ---- | 94.4 | ---- |

SOURCE: FOCUS Report X-17A-20

## RECENT INTERESTING READING AND STATISTICAL MATERIAL

| ITEM | DESCRIPTION | SOURCE |
|---|---|---|
| Competition in the Eighties | Complete transcript of Trends Conference proceedings. Topics include: emerging regulatory/ legislative and economic changes, micro and macro determinants of industry profitability, the changing customer base and strategies for the eighties. | Available on a Pre-Paid Basis<br>Order from:<br>Securities Industry Assoc.<br>Research Department<br>20 Broad Street, 19th Fl<br>New York, New York 10005<br>Price per copy: $30.00 |
| Transcript of 2/18/82 Retail RR Sales Compensation Conference. | Current practices and trends in Retail RR compensation, observations on critical compensation issues, how to evaluate Retail R.R. compensation programs, and the strengths and weaknesses of current practices. | Available on Pre-Paid Basis<br>Order from:<br>Security Industry Assoc.<br>H. Pim Goodbody, Jr.<br>20 Broad Street, 19 Fl.<br>New York, NY 10005<br>Price per copy:<br>Conference Participants: $50.00<br>All others: $100.00 |
| Stocks: Golden Opportunity of the '80s." | Author takes the optimistic view that stocks will be much in demand over the next several years, citing demographic and tax policy changes as well as the NYSE's 1981 Shareownership & Public Transaction studies as evidence. | Registered Representative<br>April, 1982 |
| "Executives Uncertain Over Stock Market Returns" | Summary of Greenwich Research pension survey findings: expected returns and projected future demand for different investment vehicles, plans for internal management of assets, etc. A large percentage of respondents indicated that they do not know what returns to expect from the U. S. stock market over the next 5 to 10 years. | Pensions & Investment Age<br>April 12, 1982 |

| ITEM | DESCRIPTION | SOURCE |
|---|---|---|
| "The Growing Love Affair with International Mergers" | Discussion of M&A business -- the growing importance of divestiture activities, recent U.S. acquisitions by foreign buyers, and firms' differing operating styles and strategies. | Euromoney April, 1982 |
| "Will America's Trustbusters Free The Fortune 500?" | A brief review of enforcement of antitrust laws in the Reagan era, the abundant opportunities for antitrust suits, and headaches created thereby for lawyers and Wall Street firms active in the M&A business. | The Economist April 16, 1982 |
| "Looking for an Appraisal of the SEC" | A scathing critique of a study entitled: The SEC and the Public Interest, jointly written by two economists. More generally, the author of the critique questions the contribution economists have made or can make in analyzing these kinds of issues -- including the SEC's Economic Directorate -- given their aversion to things qualitative. | The Bankers Magazine March-April, 1982 |
| Special Crisis Report | Report describes S&L's current crisis, chronicles developments in Washington, both legislative and supervisory, and offers some advice to management on weathering the hard times ahead. | Savings & Loan News April, 1982 |
| "Going Public: Practice, Procedure and Consequences" | An overview of 1933 Act disclosure requirements and associated issues -- advantages of going public, selection of an underwriter, etc. | The Packard Press 595 Madison Avenue New York, NY 10022 |
| "The Underground Economy's Hidden Force" | Discussion of magnitude and rate of growth of the underground economy, and resultant complications re: economic policy formulation. Author maintains that estimates of savings and productivity rates are biased downward and the rate of unemployment exaggerated. | Business Week April 5, 1982 |

Securities Industry Trends

AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

A8825-1 5/25/82

Vol. VIII No. 3 May 19, 1982

# THE STATE OF THE INDUSTRY: A SPECIAL SPRING MEETING REPORT

## Introduction

Last year, we made a presentation which laid out some of the major themes or issues affecting our industry. Since it went so well, we were asked to do it again in 1982.

The Spring meeting of SIA has a clear purpose. It is the midyear taking of account if you will, by the people who work on behalf of the industry, through its association. This meeting brings together the participants of major committees, and in a way the hundreds of dedicated volunteers who worked throughout the year, and sometimes over several years, to achieve a better industry for our clients and for ourselves. SIA could not function without active member participation. One need only think about reducing capital gains taxes, capital rules, operational streamlining, marketing and sales, educational programs, simplification of registration, and many other areas, to realize that the efforts of SIA committees have borne fruit. Of even more importance, however, is the vital need for these creative efforts to continue, as our industry passes through a time of enormous change and challenge.

Our presentation will cover the four part dimension of the industry's association -- the economic and research theme -- what is going on in the business, what is the economic impact of change on the different types of firms, and how do new regulatory and legislative initiatives affect our industry and its basic job of raising capital and advising clients?

The second phase is the legal and regulatory dimension -- whether it is in capital rules or registration and disclosure, enforcement, the licensing of firms and sales personnel, or the essential evaluation of rule proposals and I might add the inevitable litigation that seems to be with us in modern business.

Government relations in Washington require much of our industry's and association's human and financial resources, legislation must be evaluated, grass roots and lobbying activities go hand in hand with testifying to bring our point of view most emphatically before the members of the Congress. Congressional visits and fund raising are part of that process.

The fourth dimension is called member services, and it is intended to convey the association's capacity to assist members in a very practical way as we pass through an era of rapid and major change. This covers group insurance programs, management development, educational programs and sales operations, compensation, and many other areas.

I would like to mention just a few hypothetical future headlines which may pertain to our industry. Please remember that these headlines were intended to focus and not to frighten.

Headline #1 - Congress Repeals Capital Gains Taxes as a Means to Bolster Capital Formation and Balance the Budget.

Headline #2 - Glass-Steagall Modified, in Some Form, as Financial Intermediaries Begin to Function Under Comparable Rules.

Headline #3 - SEC Streamlines Capital Raising and Registration Process. Will Investors Be as Well Informed?

Headline #4 - SEC Revises Capital Rules, Freeing Up to $600 Million in Industry Capital.

Headline #5 - Regional Firms Join Forces to Offer Custom Tailored Services for Companies and to Provide Investment Programs for Large and Small Investors and Municipalities.

And finally, Headline #6 - Rapidly Changing Financial Industry Brings New Alliances Between Regulatory Agencies and Associations.

As you can see from these headlines, they are intended to be thought provoking, hardly definitive. They cover the work of SIA's committees on taxes, revenue bonds, Glass-Steagall, Rule 415, the capital rules, regional firms, marketing and a number of others. These headlines reflect the world in which we live and work, and the activities of SIA's committees.

Edward I. O'Brien

## Macro and Industry Trends

In recent years, our economy has suffered from low real economic growth. Indeed, during some quarters, we have had negative real growth. In the main, we have been plagued by high inflation and record real interest rates -- that is, nominal interest rates less inflation. These variables have acted to serve as a drag on corporate profits, particularly during the first quarter of 1982.

Surprisingly, at least until the first quarter of 1982, the securities industry escaped most of these profitability problems. Nevertheless, high interest rates and inflation have impacted personal savings flows dramatically. I would like to briefly discuss these flows.

Chart 1 shows how personal savings flows have changed over time. Traditional passbook savings deposits have dramatically declined in importance. In sharp contrast, market-related deposits were 40% of total savings deposits in 1977 and amounted to 65% by 1980. Market-related deposits have raised the cost of funds to the mutual savings banks, while also reducing their market share of total savings deposits as compared to commercial banks.

Chart 1

**Individuals' Savings**
**Net Flows at Seasonally Adjusted Annual Rates**
($ Billions)

| | 1972 | 1974 | 1980 | 1981 |
|---|---|---|---|---|
| Check Deposits & Currency | 13.9 | 7.4 | 11.0 | 20.4 |
| Savings Accounts | 74.3 | 55.9 | 134.2 | 58.0 |
| Commercial Banks | 29.1 | 34.1 | 78.1 | 54.3 |
| Savings & Loan Associations | 32.1 | 15.6 | 41.8 | 0.2 |
| Pension Fund Reserves | 22.7 | 29.7 | 77.6 | 87.7 |
| Direct Market Instruments | | | | |
| U.S. Government Sec. | (2.9) | 16.8 | 27.8 | 37.9 |
| State & Local Securities | 2.3 | 8.3 | 3.0 | 13.3 |
| Corporate & Foreign Bonds | 6.5 | 5.1 | 3.6 | (9.1) |
| Money Market Fund Shares | — | 2.4 | 29.2 | 107.5 |
| Mutual Fund Shares | (.1) | .9 | 4.4 | 7.6 |
| Other Corporate Stock | (5.1) | (1.6) | (6.3) | (33.1) |
| Increase in Financial Assets | 131.5 | 144.5 | 303.8 | 323.2 |

With regard to direct market instruments, the shift in individual flows has been nothing less than remarkable. Note particularly the flows to money market funds, U.S. government securities, and, to a lesser extent, municipal securities. In 1981, flows to money market funds came to $107.5 billion alone -- about one-third of the net increase in total financial assets of individuals. Such funds were non-existent as recently as 1972.

Individuals, attracted by high yields in the most liquid of financial instruments, purchased over $65 billion of U.S. government securities over the last two years. This represents almost twice the amount they put into U.S. government securities during the 1973-77 period. The $13.3 billion flowing into municipal securities in 1981 exceeded by far the amount flowing into such securities during any earlier year.

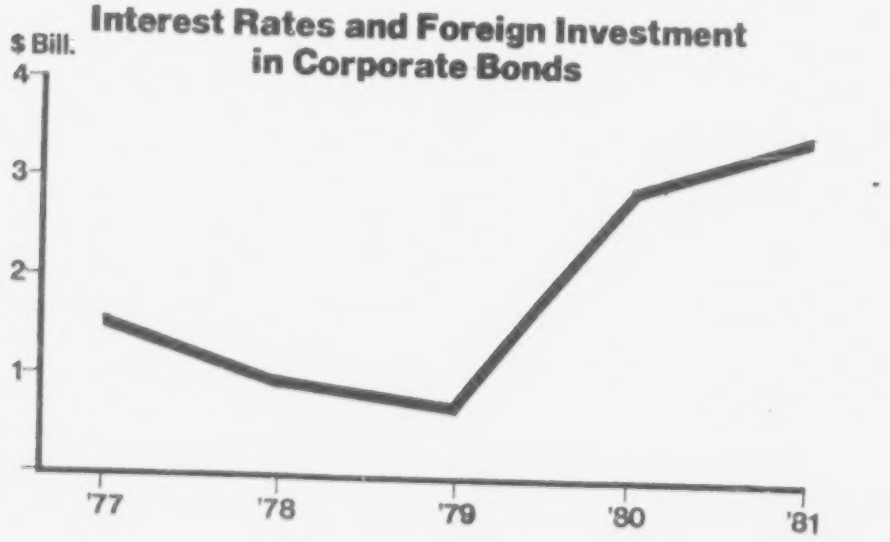
While flows were increasing dramatically to money market funds, U.S. government and municipal securities, individuals were shunning long-term corporate securities, both fixed income obligations, as well as common stock in 1981. The figures in Chart 1 are published by the Federal Reserve and may not be accurate to the last decimal place. Nevertheless, they are indicative of recent trends in individual savings flows and are amazing in terms of direction and magnitude. These trends have had significant implications for the focus of securities firms and individual salespersons.

Besides individuals, foreign investors were attracted to U.S. government securities in 1981. Their purchases amounted to $15 billion in 1981 as compared to a range of $2-5 billion from 1978 through 1980. Foreign investors were attracted to U.S. government securities in 1981 by both a strong dollar and high interest rates in this country. Interest rates were high in this country, both on an historic basis and relative to other countries. This was particularly true in real terms.

Chart 2

Unlike individual investors, foreigners were also attracted to the U.S. corporate bond market. Again, a prime motivation attracting their investment funds was the strength of the dollar which, on a trade-weighted basis, increased about 8% relative to other currencies. Like government securities, the real interest rates derived from U.S. corporate bonds provided a strong inducement in attracting foreign funds to this country. This contrasts with negative real interest rates in this country in the previous years, after adjusting for inflation in both 1979 and 1980. Despite a withholding tax on foreign portfolio investment, foreigners took down about $6.5 billion in U.S. corporate bonds in 1980 and 1981. This was a sharp reversal from their small purchases in 1978 and 1979.

Chart 3



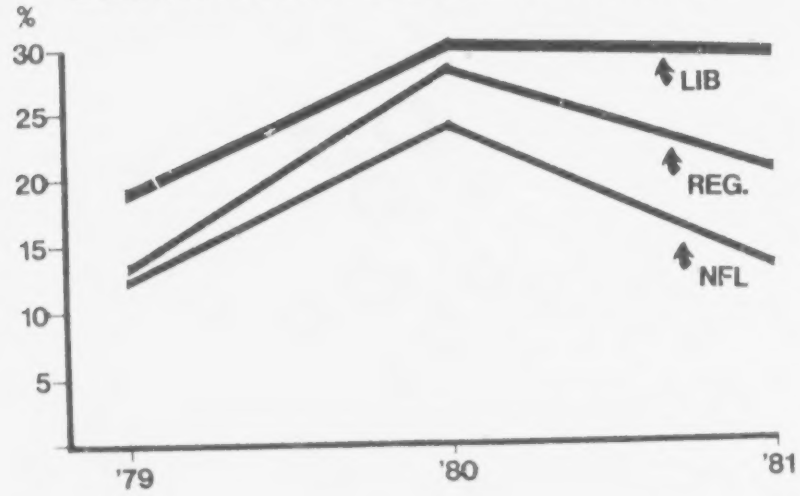

Much more has been written in the past about foreign enthusiasm for U.S. equities. This appetite continued robust in 1981 with net foreign purchases of U.S. equities reaching an annual record high of $5.7 billion. However, the dominant share of this amount was reached during the first half of 1981 with a sharp trailing off in the second half.

Different trends in investment flows by foreigners, individuals and institutions have forced firms to employ various strategies over the last few years. These different strategies would seem to have been successful, given the industry's profitability. For all NYSE firms dealing with the public, the rate of return on equity for 1979 through 1981 averaged 20.5%. Naturally, various segments of the industry were affected differently. The Large Investment Banking firms seem to have adjusted the best to this new

environment. Unlike the other firm categories, 1981 was surprisingly almost as good as 1980 for the Large Investment Banking firms. The rate of return on equity for the Large Investment Banking firms was about 30% in both 1980 and 1981, whereas for the National Full Line and the Regional firms, there was a sharp drop off in 1981. For the Regional firms, the return on equity went from 28% to 20%; for the National Full Line firms, 24% to 13%. Despite those declines, when compared to other segments of our economy, these two firm categories still performed quite well.

Chart 4

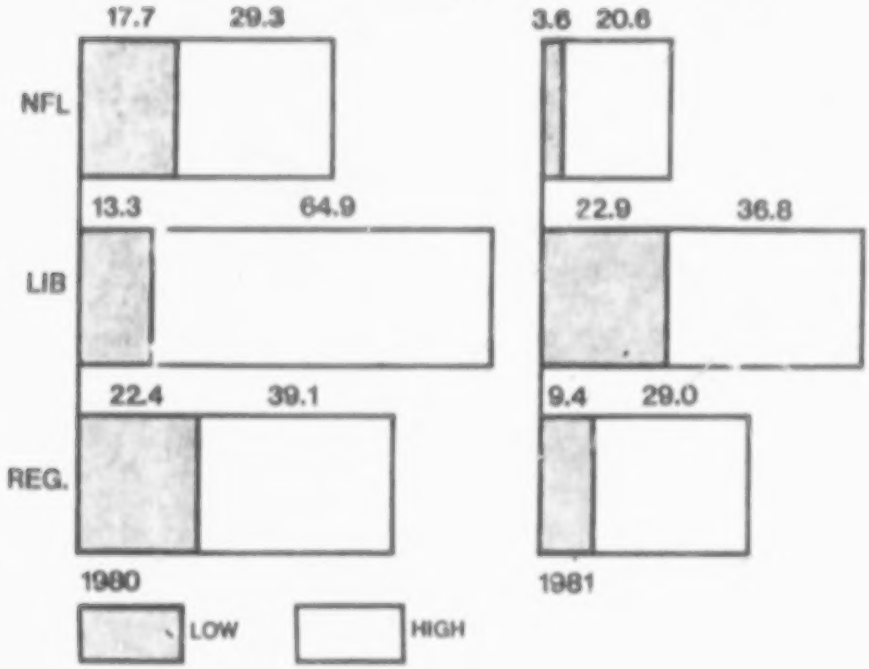
**Estimated After-Tax Return on Equity**




One question we are often asked is what has happened to earnings volatility in this industry over time. In terms of absolute variations in profits from quarter to quarter, there has been greater variability over time. On a relative basis, though, when you look at the quarterly variation and divide by the average return on equity from 1976-81, volatility is down. Chart 5 shows the high and low quarters for three categories of firms -- Regional, National Full Line and Large Investment Banking during 1980 and 1981. The Large Investment Banking firms would seem to have been the least volatile in 1981. Their low quarter was a 23% return on equity; their high about 37%. Unlike other firm categories, they escaped the bath in the third quarter of 1981. Both the Regional firms and the National Full Line firms were battered in the third quarter of 1981, earning a 9.4% ROE and 3.6% ROE, respectively.

Chart 5

**Volatility of Quarterly Return on Equity**




Rising costs remain a major problem for this industry. The problem of escalating costs was hidden by the dramatic growth in revenues recently, particularly with the ballooning of interest income. As the first quarter 1982 results are trickling in, and a slow-down in revenues are occurring, the cost increases that have built up over recent years are taking their toll on profit margins, particularly hurting the retail business. It would appear that the wholesale firms, even in the first quarter of 1982, are faring somewhat better.

Chart 6 provides data on average daily share volume. Volume on the Amex declined from 8 million shares per day down to 5 million shares from the first quarter of 1980 through 1982. NASDAQ volume, after increasing in 1981, fell in 1982. The NYSE surprisingly reached an all-time high in the first quarter of 1982, but even that number is deceiving unless adjusted properly. I adjusted NYSE volume for institutional activity, taking out blocks of 10,000 shares and over, and also excluding member trading. When this is done, you get a different handle for first quarter trends on the NYSE. As shown in Chart 7, "retail activity" on the NYSE was also down in the first quarter of 1982. This indicates that the core activity -- agency stock commission business -- in the retail sector was down for all markets, the NYSE, Amex and NASDAQ.

Chart 6

## Average Daily Share Volume

(millions of shares)

| | 1Q 1980 | 1Q 1981 | 1Q 1982 |
|---|---|---|---|
| NYSE | 46.9 | 47.5 | 51.8 |
| Amex | 8.0 | 5.9 | 4.9 |
| NASDAQ | 24.7 | 30.9 | 26.9 |

Chart 7

## "Retail" Average Daily Share Volume

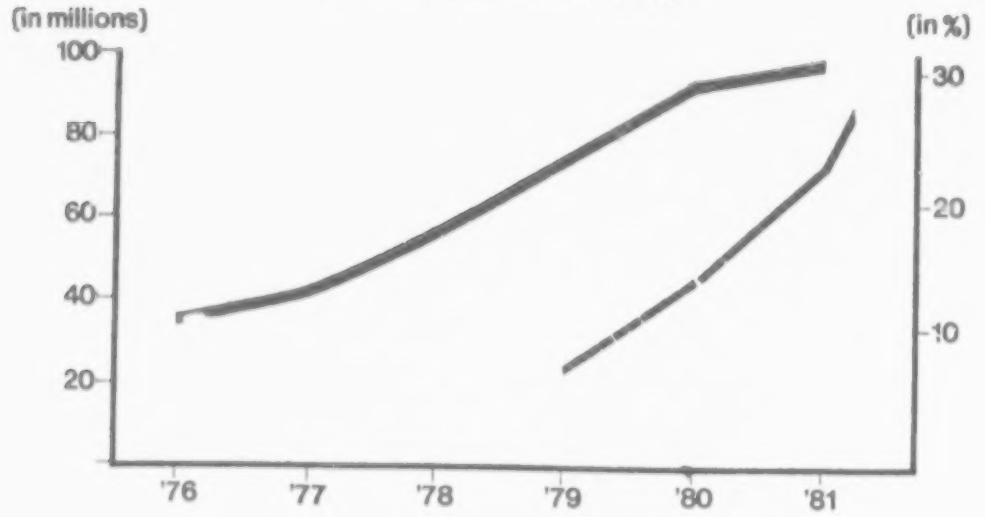
(millions of shares)

| | 1Q 1980 | 1Q 1981 | 1Q 1982 |
|---|---|---|---|
| NYSE | 46.9 | 47.5 | 51.8 |
| NYSE - (Blocks + Member Trading) | 21.3 | 20.9 | 18.4 |

Such trends support the diversification strategy to bolster profits and reduce volatility that the industry has followed in recent years. Chart 8 indicates a new area of diversification -- futures -- that exemplifies this trend. This chart shows the absolute increase in futures and then takes financial futures as a percentage of all futures. All futures contracts jumped from 40 million contracts in 1977 to about 100 million in 1981. More importantly, financial futures have ballooned in terms of relative importance from 7% in 1977 to 27% by the first quarter of 1982.

Chart 8

Futures Contract Volume and Comparative Growth of Financial Futures




This last chart is very important in terms of future industry trends. If people are satisfied that the country is making real progress in fighting inflation, we will once again see financial instruments preferred over tangibles. That will be a healthy trend for all of us.

Another new area to be exploited by our industry is IRAs. For the mutual savings banks alone, IRA accounts were worth $2.7 billion by year-end 1980, and that was before the law was liberalized. Now that the law is changed, IRA and Keogh plans should represent a potential expanding market.

It would appear that the industry's core activities -- selling stocks and bonds and underwriting corporate and government securities -- should revive if the improvement in inflation and interest rates are for real. Nevertheless, some serious problems remain. The current budget impasse represents a problem in terms of potential turbulence to the financial markets. Despite diversification, this remains a "feast or famine" industry. The whole idea of relying on interest rate spreads to generate profits would seem to be eroding as competition is eliminating these spreads and as interest rates start winding down.

Finally, the future legislative, regulatory and managerial changes will be more important than ever in terms of impacting securities industry profitability. These will be covered to some extent in the remaining sections of this paper.

Jeffrey M. Schaefer

## Regulatory and Legal Developments

There are a great many regulatory initiatives in the course of a year, and SIA monitors them all to protect your interest. I will only discuss a few of them. Temporary Rule 415 is one of the most important regulatory developments this year. Shelf registrations have been with us for a long time. Issuers have always been able to register securities for employee stock purchase plans, for rights offerings and for secondary offerings by individuals by use of shelf registrations. The SEC had special rules for handling such registrations known as Guide 4. Rule 415 abolished Guide 4. It consolidated all the rules for shelf registration and also enlarged them to permit issuers to use them in direct offerings to the public. That is the unique feature of 415.

The SEC has maintained that this is merely a procedural change, and one that has little, if any, substantive meaning. They point to recent offerings under Form S-16 (that is the form that's been with us for several years now and is the abbreviated form of registration). The SEC maintains that quick offerings sold to one or a few underwriters have existed in the market place prior to 415, and that the new rule is nothing except the last stop of a long evolutionary process.

SIA from the beginning has responded to the SEC initiatives, and we said that more impact data and more information were needed, before this experiment takes place. The Corporate Underwriting Committee is attempting in a very short time alloted to us before public hearings beginning on June 28, to look at the entire phenomena of fast registrations and their effects on investor disclosure, due diligence, syndicates and the effects on primary, and secondary markets. It is our hope and intention to develop intelligent, worthwhile testimony which will help the SEC in its further deliberations. We ask all our members to cooperate with this committee in the production of such data.

As you know, 415 was part of a very large package of releases which dealt with integrated disclosure, allowing issuers greater latitude in adapting the regular filings that they make under the 1934 acts, (the annual reports, the 10Ks, the 10Qs, etc.) to use them in the registration of new offerings. One of the most interesting rules in the package is Rule 176. This rule is of importance to underwriters, since it provides standards for due diligence. One of the standards to be used in determining if reasonable inquiry has been made is the availability of information to the underwriter. All of this can prove extremely helpful in these quickie offerings, if called upon to prove the performance of adequate due diligence.

Another regulatory development has been the turf fight between the SEC and the CFTC. I will restrict my remarks to the legal arena. There is a battle raging in court between the CBT, (the Chicago Board of Trade) and the CBOE, (the Chicago Board Options Exchange), in which the CBT was trying to enjoin the SEC from permitting the CBOE to trade GNMA options. The case went to the seventh circuit in Chicago, where a three judge panel - with one of the judges dissenting rather vehemently - decided that the CFTC had exclusive jurisdiction over GNMA options, and worse yet, that the SEC had very questionable jurisdiction over any option, since the court concluded that options were not securities.

The SEC then asked SIA to assist them in obtaining a rehearing before the entire seventh circuit. SIA did - we filed an amicus brief, asking the seventh circuit to rehear the case because of the possible chaos into which option markets can be thrown if the decision is left standing. I think this points out the unique position of SIA because of its objectivity to come into cases such as this, which have such importance and impact on the industry and to assume the role of amicus, (that is, friend of the court).

Another regulatory development was the reforming of the capital rules. The capital rule amendments are on track. As of this month, you should be getting some much needed and warranted relief. The SEC fully expects to have most of the package in place by the middle of this month and we are hopeful that most of the reforms that were requested will be granted. There may be some disappointments, but thanks to the very hard work of SIA'S Capital Committee, substantial improvements in available capital will be experienced immediately. Of course, as you know, the major reduction will be a reduction from 4% to 2% for reserves against customer debts.

There are many straws in the wind from a regulatory and legal standpoint. SIA monitors not only the SEC initiatives, but also those of the CFTC, the Federal Reserve, the Department of Labor, all of the self-regulatory organizations and the states. SIA comments on all important proposals. We also publish a quarterly Regulatory Review which summarizes all new rules and proposals during that quarter. I could go on forever, but from the glazed look in the eyes of the audience, I will terminate my portion of the presentation.

William J. Fitzpatrick

Legislative and Washington Developments

I am going to try and make a little sense out of Washington developments, which is usually difficult, and this year borders on the impossible. In many cases, legislative policies are being molded less by arguments and coalitions than by jurisdictional disputes, judicial decisions, economic conditions and, of course, partisan politics.

For example, two regulators have been squabbling for years over which has the proper regulatory authority for the new developing financial instruments designed to hedge interest rate risks. Until the CBOE proposed trading of GNMA options, and the SEC approved these instruments, there had been only short jabs, but now the CFTC claimed exclusive jurisdiction and the CBOE sued.

Fortunately, the regulators realized that this confused alphabet soup was counterproductive and costly and they decided to agree and divided the jurisdiction. Well, not a perfect agreement, but the SIA endorsed this agreement and told the Congress that it thought it was time to get on with it. The Congress began to legislate, and then the court decided that the CFTC was right, and here we are in a confused mess, and if you add in the federal reserve's ability to set margins, and you stir in the fact that two different congressional committees have jurisdiction over the two regulators, then the soup becomes a messy chowder. Hopefully, Congress will approve the Shad-Johnson agreement and we can get on with our business, but I'm not convinced of that.

The next example is legislation to deregulate the telecommunications industry. Congress began this effort in earnest four years ago, about six years after the Justice Department had filed suit. Obviously, the court case had been chugging along, and so had Congress, and late last year, the Senate passed the telecommunications legislation.

Then, all of the sudden, the justice department settles the case. The House reacts with new legislation, hearings and demands. The Senate reacted with great rhetoric and the court puts out a ringing assurance that it alone will determine whether or not the settlement is in the public interest. One can't be certain, but Ma Bell just may be deregulated in 1982. Hopefully, it will produce greater competition and lower communication costs to the second largest users of communication services, the securities industry.

Changes by financial institutions are putting enormous pressure on the Glass-Steagall Act. One year ago, it appeared as though a handful of institutions were testing the barriers from both sides. Today it looks like it's everyone into the pool. Banks are buying broker/dealers; thrifts are seeking to become broker/dealers; and an SIA member is currently being purchased by a mutual savings bank. Banks are rushing to set up asset management accounts and broker/dealers are running as quickly to help them set such accounts up. Thrifts are seeking to offer mutual funds; brokers are buying state non-member banks and setting up trust companies. Banks are establishing subsidiaries that look just like broker/dealers and one is capitalized at $175 million, a figure higher than all but the top 10 brokerage houses.

Markup on Senator Garn's bill could occur tomorrow, and 238 Congressmen have endorsed bank underwriting of revenue bonds, including the majority of the House Banking Committee. The Administration would like to permit banks into the revenue bond business through a separate subsidiary, and then ultimately into the entire securities business. The plight of the thrift industry adds enormous additional pressures. In short, the erosion of the Glass-Steagall Act appears closer than ever, and not surprisingly, SIA's resistance to a piece meal erosion is the strongest and most expensive ever mounted.

Economic conditions are forcing the Congress to face the grim reality that the deficit over the next four years could total $750 billion. That shocking total equals 3/4 of the total debt run up by this nation in the past two centuries. It also approximates the size of the underground economy, prompting the calls for improved tax collection, including the reporting on securities and commodity transactions. By coincidence, the $750 billion also approximates the five year cost of last year's tax bill. Legislators from both parties, the infamous gang of 17 now, tried very hard and came very close to an agreement on spending cuts and tax increases during six weeks of meetings. Unfortunately, the two principals involved, the President and the Speaker, could not agree.

The debt ceiling, which comes up just about every year, is going to have to be increased in the next five to six weeks. It would appear as though this will become the vehicle for the budget and tax compromise, but if agreement on the budget and taxes is not reached by that time, I think the outlook looks very bleak. Congress may not be able to come to an agreement at all. They would then have to pass continuing resolutions to keep the government going, postpone resolution of the budget and tax matters

and hopefully review them after the elections. In such a case, I think you can see the potential catastrophic effects on the economy.

Clearly, the projected deficits cannot be narrowed to acceptable levels without severe spending cuts in all programs and significant increases in Federal revenues. The big ticket items, which have divided the President and the Speaker continue to be there, social security, defense spending, the third year of the tax cut - they are still unresolved, but must be addressed and resolved.

But if they couldn't do it in private, I really question whether they are going to be able to do the exact same thing in public, which is now what they're proposing to do. We fervently hope for their success, but frankly I think I'd bet against it. Any tax bill that would be passed would become and can become a Christmas tree containing special interest amendments. We hope that doesn't occur. But our recently released six-month holding period study for capital gains will give us ammunition for adding this potential revenue raising measure.

This is not an uplifting report, but I think it is sadly realistic. The prospects for legislative gains for the nation and for our industry are few, since the persistent economic problems must be solved and they are going to be solved in a much stronger, partisan political atmosphere. Fortunately, we have all survived worse.

Donald J. Crawford

## Retail Sales and Marketing

My remarks will center on retail sales and marketing, and, as I think everyone in this room knows, there are a great many things happening in this segment of the business these days. In fact, there's more happening than we have time to discuss, so what I thought I'd do is this:

First: Take only a couple of minutes to do little more than simply mention a number of trends that we believe are very significant and then...

Second: Devote the bulk of my time to taking a more detailed look at one particularly important subject; namely, the challenge of retaining your brokers.

So let's start by mentioning some key trends and developments in sales and marketing. In number, they add up to a banker's dozen. In case you didn't know, in contrast to a regular dozen or a baker's dozen, a banker's dozen equals six.

1. The first of the six trends is this: More and more firms are attempting to put the brakes on new product offerings and concentrate instead on assimilating and broadening the use of existing products. Product pollution is fast becoming a no-no. Product penetration is fast becoming a yes-yes.

2. In the face of this general desire to gain greater control over, and value from, existing products, it is nevertheless an important fact that the exchanges are developing a whole new, large and fairly complex family of products--namely, stock index futures. And it's a family that may soon include a good many cousins, called options on stock index futures. How will these products be accepted by firms, given the overall desire to limit new product offerings? They could well be big, but I suspect a weight-of-the-market test will be important. That is, if there is substantial customer interest, no doubt firms will respond. If not, it could be very difficult to gin up interest.

3. The third development also runs counter to the trend towards limiting and consolidating products, and I'm talking now about the introduction of cash management type accounts. Although there are a few firms that have at least tentatively decided not to offer such a product, my sense is that within a year or two at the outside, such products will be found throughout our industry. Access to these products via wholesalers of various kinds will accelerate the trend.

4. Retail discounting seems to have reached a plateau. Last Saturday marked the seventh anniversary of May Day, and it could be that the discount segment of the market has now reached its peak.

5. The fifth development is that our industry is getting more mileage out of money market funds. There are still problems, to be sure, but we see evidence that some firms are improving the percentage of commissionable sales that follow fund sales. We see a number of firms applying modest but important transaction charges on fund purchases and sales. And we see more and more firms experimenting with ways to relieve their RRs of some of the paperwork and servicing burdens that come with money market fund business.

6. The sixth and last trend I'll mention is that there is a growing awareness that the tree of selling costs must not be permitted to grow to the sky. Selling costs--not only sales comp and fringes, but very importantly, sales support costs--have marched steadily higher, causing a squeeze on profit margins that most firms now clearly recognize. My guess is that over the next year or so we'll begin to see a good deal of ingenuity and creativity exercised as firms search for ways to bring selling costs under better control.

Let's focus on that one particularly important subject I mentioned earlier: The challenge of keeping your brokers.

Under the auspices of SIA's Marketing Committee, a landmark study was recently completed that gives us first-time, industry-wide information on why RRs switch from one firm to another. We believe it is the most comprehensive study ever conducted within our industry on this subject.

The end product of that study is a 99-page report, so clearly, all we can do is touch quickly on just a few of the highlights... with the help of some charts.

**RR Retention & Turnover Study**

- 58 Sponsoring Firms
- 2,500 RRs Who Switched

We lined up 58 firms as sponsors of the study. They not only provided the funding, but also gave us access to those RRs who joined their firms from other firms after January 1, 1979. With the help of Management Decision Systems, an 84-item questionnaire was fashioned. Working through the sponsoring firms, just over 2,500 recently-acquired RRs completed and returned the questionnaire.

This chart capsules what we learned about the 2,500 RRs who switched firms.

## Profile of the Movers

- Younger
- Fewer years in production
- History of mobility
- Typical production levels

• First, on average, they're a good deal younger than the RR population as a whole. The median age of the movers was about 37--compared with a median of about 47 for all RRs.

• Second, they tend to have fewer years in production: 47% of the movers had fewer than five years in the business. While the early years are clearly the most movement-prone years for RRs; however, a firm cannot depend on its veteran producers to stay put...because 33% of the movers had 10 or more years in production.

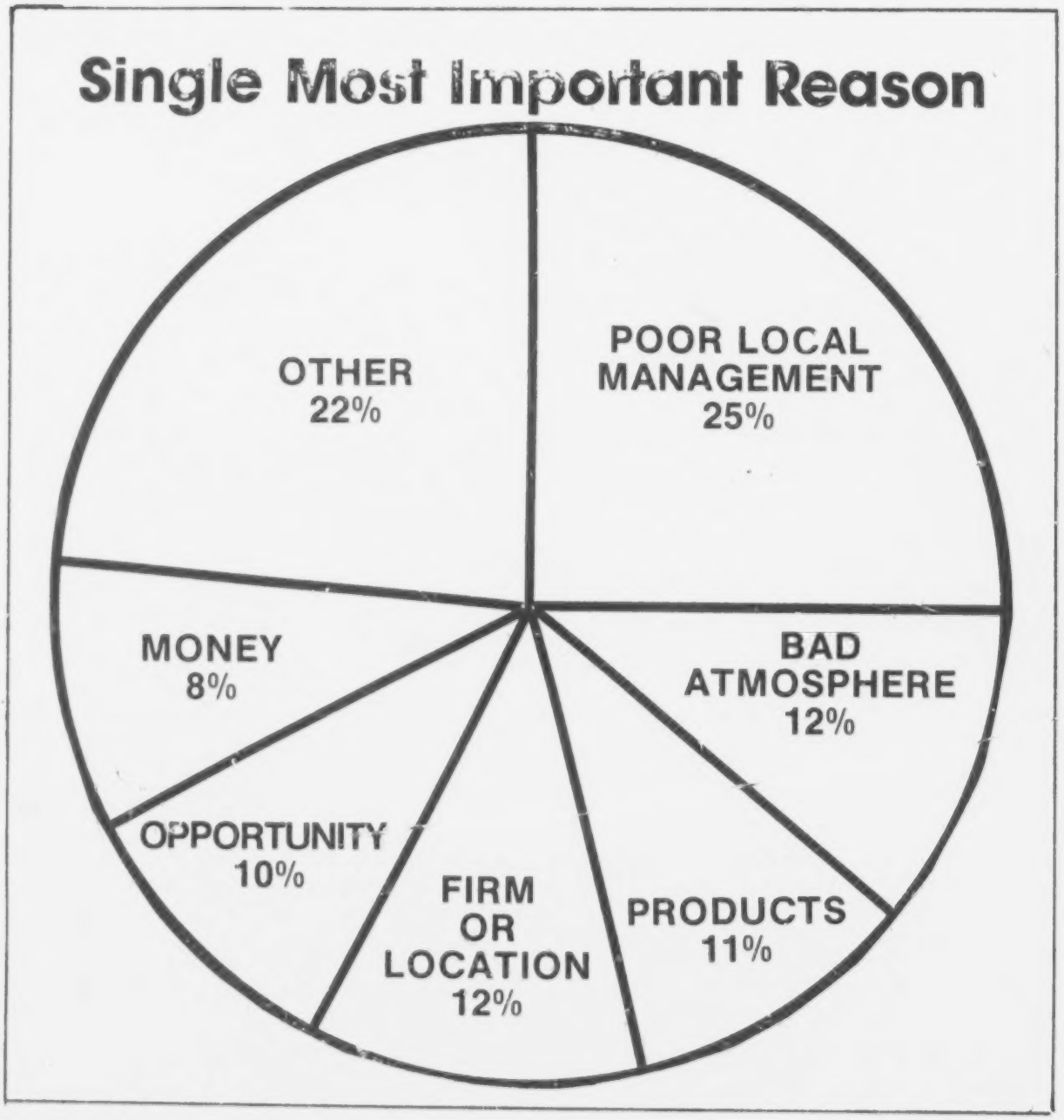
• Third, as a group, the movers have a history of mobility, as 27% of them had been with three firms; another 14% with four; and another 12% had been with five or more firms!

Backing up this point on mobility is the fact that close to half the 2,500 surveyed had been with their prior firm for less than two years.

• Lastly, in terms of production, the median level among the movers was within a few hundred dollars of the industry-wide median.

Why did they move?

We asked each to write in the single most important reason he switched.




One-fourth pointed directly at unhappiness with the branch manager. Another 12% pointed to a bad atmosphere, including lack of professionalism and poor working conditions--factors that typically turn on the quality of local management.

A variety of other concerns completed the pie:

Note that "money" reasons--such as payouts and incentives--were named as the number one reason by only 8%.

The "other," at 22%, included personal reasons, mergers, involuntary terminations and the like.

The key point is that, by far and away, the local branch manager is crucial in the turnover-retention picture. And, the bigger the producer, the more likely it is that he points to the branch manager as to why he moved on.

The questionnaire included 36 different statements that asked the RR to compare his new firm with his former one.

**"Offers Greater Opportunity to Increase My Production"**

"Offers greater opportunity to increase my production" was by far the statement rated true by the highest percentage--almost all of whom went on to indicate that this expectation of greater production in the new firm was a "very important" reason for making the change.

How does this square with the finding that "poor local management" was the most common number one reason for making a change? It squares because a negative factor such as poor management becomes a problem for an RR when he feels that factor is impeding his production. One solution, therefore, is to move to a new firm where he believes his manager will help and not hinder his production performance.

A central conclusion of the report therefore is this: Removal of production impediments and enhancement of production opportunities are the foundation of any RR retention program.

Here are some findings concerning the circumstances surrounding the move.

## THE MOVE

| | |
|---|---|
| • Front Money | 15% |
| • Transition payouts | 63% |
| • Minimum guarantees | 82% |
| • Took the initiative | 56% |
| • Left without pressure | 82% |
| • Switched locally | 88% |
| • Had offer in hand | 86% |

• Only 15% say they received cash up front--much lower than industry perceptions.

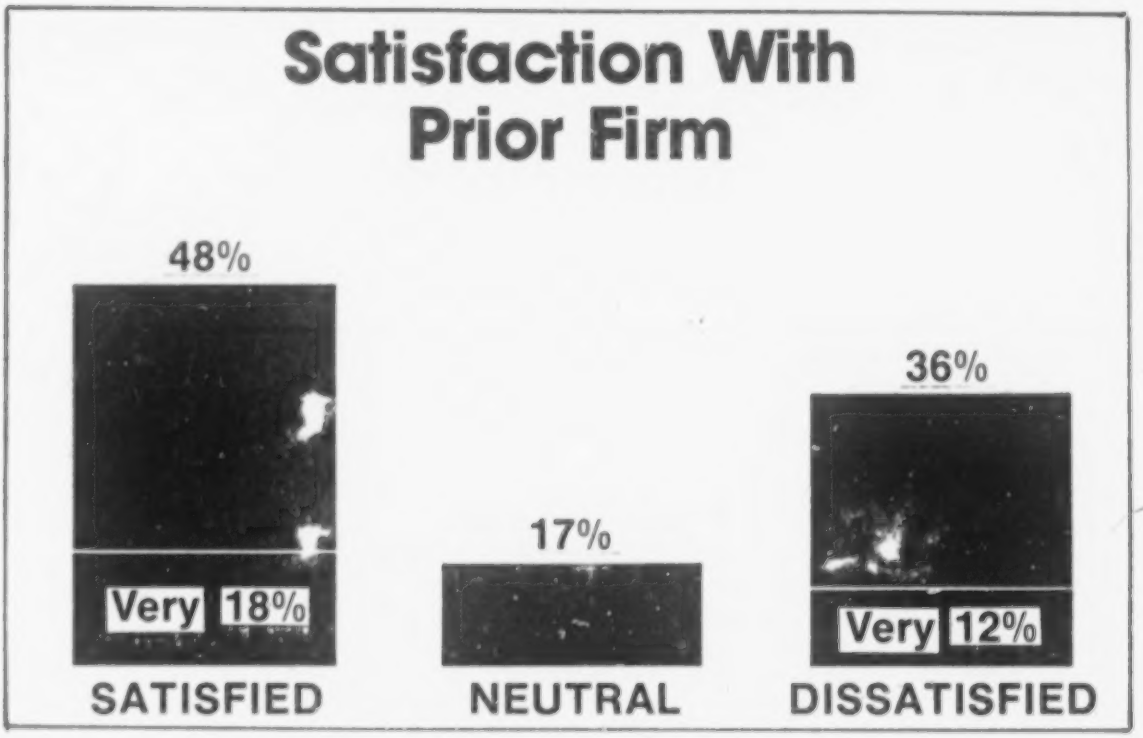
• 63% were given higher-than-scale transition payouts.

• Most received minimum guaranties.

• Just over half say they were not recruited but took the initiative to find other pastures.

• And high percentages say they left without any pressure to do so, that they switched to a local competitor and that they had an offer in hand when they walked out.

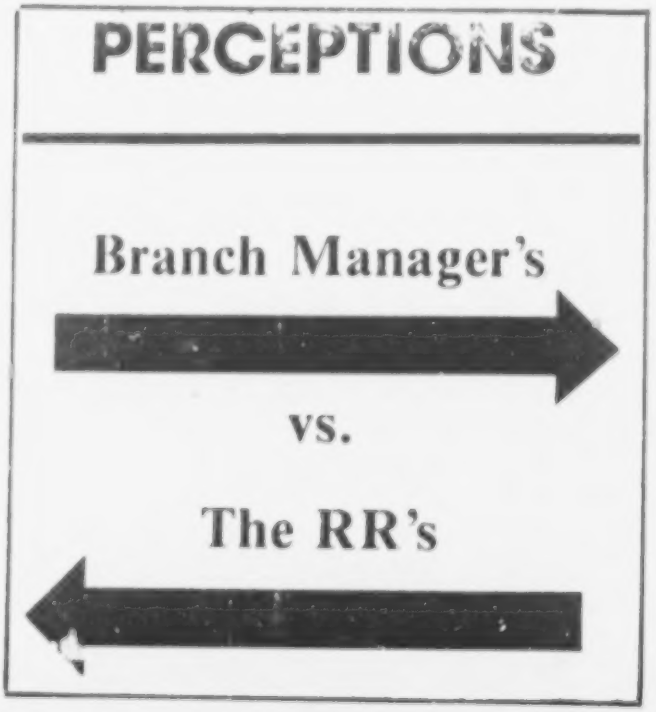
Here's an interesting finding.




It shows that by 48% to 36%, the RRs who moved were satisfied vs. dissatisfied with their former firms. And more were very satisfied than very dissatisfied.

The main point here is that it is a mistake to assume that so long as a broker is happy, he'll stay with you.

As a part of the study, personal interviews were conducted with a number of the RRs -- 33 gave permission to contact their former branch managers and compare what the RRs said with what the branch managers had to say as to the reasons the RRs moved on.



As this chart suggests, the perceptions were dramatically different. There are many possible reasons for these differences, including the possibility that the managers' views are colored by self-interest and self-esteem.

But whatever the reasons, the conclusion is unmistakable. Any firm wishing to understand and reduce its turnover runs a considerable risk if the core of its information gathering is vested solely in the branch manager.

This chart presents some data on how the RRs settle into their new homes.

## SETTLING IN

| | |
|---|---|
| • Retained 75% or more of A/Cs | 67% |
| • Restored production within 6 months | 69% |
| • Expectations being met | 90% |
| • Satisfied | 89% |
| • Believe will produce more | 86% |
| • Expect to stay | 87% |

• Most were able to get a high percentage of their customers to move with them.

• Most were back up to full speed production within six months.

• And, very high percentages said their expectations were being met. They were satisfied. They believed they would produce more in their new firms. And, they expected to stay there.

These numbers put some dimensions on the challenge of retention.

Most of what I've covered centers largely on the nature of the turnover problem. The full report gives equal attention to possible solutions and opportunities. Two of the most important

steps a firm can take in structuring an RR retention program are listed below.

Neither is a shocking surprise--but both are absolutely crucial.

**TWO DOMINANT POINTS**

1. **Branch Managers**
2. **Opportunity to Produce**

First, you've got to have, buy or build strong branch managers. The study shows that without strong managers you just won't be able to get the retention job done.

Second, you've got to make a vigorous, genuine and successful effort to remove production impediments and give your producers the maximum opportunity to produce.

Adrian L. Banky

## Conclusion

On the all important question of taxes, we will continue to build on the arguments which were made in 1978 and 1981, by demonstrating with testimony, lobbying and evidence, that targeted tax reductions have a real value in helping our country raise capital. In many cases, reducing taxes has a favorable impact on federal revenues. In other instances where that is not the case, the overriding goal of lower taxes for our fellow citizens may be a price worth paying when it leads to increased numbers of jobs and the raising of capital.

At the present time, there is no real evidence that increased reporting of capital gains or widened powers to require interest or dividend reporting is either in the public interest or even economical for that matter. Above all, our industry can consistently support full payment of taxes by everyone who has a taxable event. The reduction or elimination of the holding period will be a top priority for our tax committee, as well as for the grass roots network which worked so effectively last year.

On the question of the financial services industry restructuring, one cannot with great enthusiasm always embrace the concept of competition. The fact is that we must accept that concept, if not with enthusiasm then at least with understanding. However, we must insist that the nation's banking and thrift industries begin to break down the protectionism which they have fostered and perpetuated for decades. Some examples of course are interest rate ceilings and geographical boundaries. We should continue to demonstrate the prudence of maintaining the differences between deposit and investment banking institutions as reflected in the Glass-Steagall Act. We should emphasize the lessons of past mistakes, as well as the present risk of forgetting those lessons. Finally, we should show clearly that the so-called advantages to the public by dismantling this common sense separation is both illusory and in fact imprudent.

Our challenge on the regulatory front is to continue to support strong enforcement as part of the self-regulatory system, while at the same time be insisting on deregulation of outdated and costly SEC and other rules. After all, our job is to raise capital, to advise our clients and to provide financial services to them as inexpensively and as efficiently as possible. We must be alert, however, to any rules or systems which threaten our ability to do our basic capital raising and advisory job.

Last but not least, we must through our board and executive committee, through SIA committees and staff, continue to work with our industry at this time of great change. Our goal must be to keep our services current and practical and that goal applies to

all of our educational, economic and regulatory services. Above all, it is important for the vibrant organization which SIA is to continue to enjoy its greatest asset -- the generous and talented support of its members.

Edward I. O'Brien

Edward I. O'Brien
Adrian L. Banky
Donald J. Crawford
William J. Fitzpatrick
Jeffrey M. Schaefer

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AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

Vol. VIII No. 4 June 16, 1982

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# THE YEAR IN REVIEW: 1981

## HIGHLIGHTS

1. In 1981, the securities industry earned an after-tax return on equity (ROE) of 19.2%. Although down from 1980's record 26.3%, the 1981 ROE exceeded that for 1976 and 1979, two years considered exceptional for industry profitability.

2. By year-end, equity capital reached $6.7 billion, nearly double the level only three years earlier. This figure reflected increases resulting from retained earnings and capital infusions from new corporate parents.

3. At year-end 1979, there was only one firm which accounted for more than 5% of the industry's equity capital. By the end of last year, there were five firms with that distinction.

4. The ROE varied considerably among firm categories. This percentage ranged from a high of almost 30% for the Large Investment Banking firms to a low of 13.2% for the National Full Line firms. The Regional firms enjoyed a return exceeding 20%.

5. Underwriting revenues were up sharply last year and have doubled since 1979. This increase is attributable to a sharp spurt in equity offerings and the new issue business, in particular.

6. For some time, institutional volume has exceeded retail volume on the NYSE. Since the fourth quarter of 1980, it is apparent that member trading also exceeds the retail segment on the NYSE. This further weakens the relationship between exchange volume and commission revenues.

## Introduction

As the securities industry entered 1981, many observers considered its greatest problem to be that of sustaining the previous year's level of profitability. That it failed to do so is not surprising. Its 1981 after-tax earnings of $1.2 billion,* on revenues of $19.8 billion, however, were a disappointment only by the standards of 1980. The industry's estimated after-tax return on equity (ROE) was, at 19.2%, well above that achieved in either 1976 or 1979, both of which had been considered exceptional years. It is particularly interesting, given the securities industry's cyclical nature, to review the year quarter-by-quarter.

The first half of the year represented a continuation of 1980, with an active agency business, both retail and institutional, and a boom in equity underwriting. Interest rates, though high, displayed some stability, creating favorable conditions for the margin lending business in particular. The emergence, in mid-summer, of an apparent conflict between fiscal and monetary policies produced an effect comparable to that felt after the monetary upheavals of October 1979. The prospect of immense Federal deficits kept interest rates at or near record levels, devastating debt and equity markets alike, and further dampening an already weak economy. From the industry viewpoint, the most noteworthy third quarter development was the conspicuous drop in retail activity. The fourth quarter saw a substantial earnings recovery, but it was a recovery in which institutional firms, emphasizing heavily their investment banking services, were the main participants.

In reviewing the industry's 1981 experience, earnings fluctuations are perhaps less significant than the structural changes which took place. Indeed, in no single year since the early 1970s has the industry structure undergone comparable changes. The securities industry, particularly its retail segment, has seen its own structure evolve from partnership to private corporation to public corporation. This generalization, obviously, applies to a small number of firms with a large market share. Other aspects of this evolution are an enlargement of scale and product diversification. The mergers of 1981 and retention of earnings boosted equity capital to $6.7 billion by year-end, nearly double its level only three years earlier. To the extent that this figure reflects capital contributions from new corporate parents, it is qualitatively as well as quantitatively different from earlier years' figures.

Diversification, too, made great strides in 1981. The decline in commissions' relative importance has long been noted in this publication, but the mergers of the past year give an entirely new

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* Estimated after-tax.

meaning to product diversification. The securities industry's relatively small size makes it easy for outsiders to effect massive changes upon entering. The result has been a narrowing of the gap dividing the securities industry from other sectors of the economy. Other economic forces, notably the recent level of interest rates, have narrowed the gap dividing broker/dealers from other financial intermediaries.

Earnings fluctuations and structural changes are closely related, the latter being precipitated by the former. This issue of Trends will attempt to put both in some perspective.

## Large Firms vs. Small

The largest firms in the industry did not become more profitable in 1981, either in relation to their own 1980 performance or to the 1981 performance of smaller firms. Business mix had a far greater impact on performance than did firm size, as will be discussed below. Table 1 gives 1981 ROE figures for the Top Ten, Second 15, and All Other firms. The third quarter figures cannot be interpreted as evidence of scale economies but, rather, they result from the third quarter retail downturn.

Table 1

| | 1Q | 2Q | 3Q | 4Q |
|---|---|---|---|---|
| Top 10 | 25.5% | 22.6% | 12.5% | 20.5% |
| Second 15 | 27.1 | 22.6 | 2.2 | 22.6 |
| All Other | 26.4 | 24.8 | 3.8 | 21.4 |

If not more profitable, the large firms did become considerably larger during 1981. At year-end 1979, there was one firm in the industry which, individually, accounted for more than 5% of the industry's equity capital. Two years later, there were five such firms. The much-publicized mergers of 1981 have enabled several firms to tap the financial resources of Corporate America; subsequent capital infusions have virtually redefined the notion of a large securities firm. By early 1982, a pattern was evolving whereby large firms were acquired by outsiders and used this new backing to acquire Regional firms. The stated objective in most such combinations was to offer the broadest array of financial services and products to a network of retail customers. Whether this objective is attainable is, for the moment, of somewhat secondary importance. The new entrants believe in this synergistic potential and pursue it with financial resources that greatly exceed Wall Street's own. Regardless of the future success or failure of these ventures, a major structural transformation is under way.

Concentration, as measured by the largest firms' market share, increased significantly during 1981. Most of the increase was in the market share of the Top Ten firms, reflecting the mergers that took place during 1981. Insufficient profitability has traditionally led to further concentration in the securities industry. The 1981 experience was a deviation from that trend in that a high level of profitability, and not the lack thereof, served as the catalytic agent.

Table 2

Market Share of Largest Firms, 1975-1981

Gross Revenue

| | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 |
|---|---|---|---|---|---|---|---|
| Top 10 | 40.1% | 41.6% | 41.4% | 44.5% | 48.4% | 52.8% | 55.5% |
| Top 25 | 58.1 | 60.3 | 62.4 | 70.7 | 70.1 | 72.3 | 74.4 |

Commissions

| | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 |
|---|---|---|---|---|---|---|---|
| Top 10 | 32.8% | 34.6% | 33.7% | 37.9% | 39.1% | 44.1% | 42.5% |
| Top 25 | 52.8 | 53.9 | 55.4 | 64.8 | 63.6 | 64.6 | 63.0 |

Year-End Total Capital

| | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 |
|---|---|---|---|---|---|---|---|
| Top 10 | 42.5% | 43.8% | 43.5% | 44.9% | 46.8% | 50.1% | 51.9% |
| Top 25 | 59.5 | 61.3 | 64.3 | 68.9 | 67.7 | 68.9 | 71.4 |

It appears that this trend towards increased concentration will continue. The level of merger activity in early 1982 speaks for itself. There exists, too, a new degree of uncertainty on both the regulatory and economic fronts. The 1981 figures fail to reflect fully the impact of mergers which took place during that year, because the newly merged entities have not had sufficient time to establish operations on the scale envisaged by their respective corporate parents.

## Profitability by Type of Firm

There was no direct relationship between firm size and profitability throughout 1981. A far more important consideration was the retail/institutional mix of a firm's customer base; institutional firms were at an advantage, particularly in the second half of the year. The Large Investment Bankers had the highest return in all but the second quarter, when Regionals gained a narrow edge. Large Investment Bankers were successful in weathering the third quarter, especially in comparison to the National Full Line firms. The highest figure in the table below is the Large Investment Bankers' fourth quarter ROE; these firms made the most of primary and secondary market opportunities created by falling rates around the middle of that quarter.

Table 3

Annualized Quarterly After-Tax Return on Equity, 1981

| | 1Q | 2Q | 3Q | 4Q | Full Year 1981 |
|---|---|---|---|---|---|
| All Firms | 26.2% | 22.8% | 7.8% | 21.1% | 19.2% |
| National Full Line | 20.6 | 19.4 | 3.6 | 10.8 | 13.2 |
| Large Investment Banking | 34.1 | 28.7 | 22.9 | 36.8 | 29.8 |
| Regionals | 25.2 | 29.0 | 9.4 | 19.5 | 20.4 |
| NYC Based Regionals | 35.9 | 25.0 | 5.3 | 28.6 | 24.1 |

It is significant that the National Full Line firms had the lowest ROE in each quarter; their willingness to purchase Regionals at three times book should be assessed in this light. The NYC Based firms, also, are interesting both for their profitability and their volatility. These differences in return are produced by economic forces at work within and outside the securities industry, forces that will be discussed in detail below.

## Revenues

As in 1978, the securities industry achieved record revenues without record profits, due to the high level of both interest revenues and interest expense. As a result of high interest rates, industry revenues increased 23.6% from 1980 to 1981, while expenses increased 28.3%. Revenues are shown below.

Table 4

Securities Industry Revenue Breakdown, 1981
(millions of dollars)

| | 1Q | 2Q | 3Q | 4Q | Full Year 1981 | Percentage Change 1981-1980 |
|---|---|---|---|---|---|---|
| Commissions: | | | | | | |
| Listed equities on an exchange | $1,020 | $1,104 | $ 901 | $ 925 | $ 3,949 | (6.7)% |
| Options | 170 | 143 | 150 | 149 | 610 | (14.7) |
| Other | 181 | 233 | 171 | 194 | 781 | 7.1 |
| Total | 1,371 | 1,480 | 1,222 | 1,268 | 5,340 | (5.9) |
| Trading | 1,111 | 937 | 839 | 1,356 | 4,241 | 35.2 |
| Investment | 256 | 126 | (16) | 209 | 575 | 2.7 |
| Margin Interest | 701 | 736 | 801 | 654 | 2,890 | 38.4 |
| Underwriting | 351 | 493 | 323 | 406 | 1,572 | 18.4 |
| Mutual Fund Sales | 22 | 39 | 27 | 35 | 122 | 16.2 |
| Account Supervision | 59 | 69 | 65 | 85 | 275 | 56.3 |
| Research | 2 | 3 | 7 | 6 | 16 | 6.6 |
| Other-Related | 578 | 655 | 735 | 992 | 2,958 | 71.6 |
| Commodities | 147 | 131 | 152 | 153 | 581 | (7.2) |
| Other-Unrelated | 264 | 300 | 372 | 293 | 1,228 | 109.2 |
| TOTAL | $4,858 | $4,964 | $4,523 | $5,451 | $19,794 | 23.6% |

* Numbers may not add due to rounding.

Source: FOCUS - provided by the NYSE.

Commissions declined both in relative and absolute terms. They accounted for 27% of 1981 gross revenues, the lowest percentage ever. As the table shows, they declined 5.9% from 1980. The retail slowdown is evident in the third and fourth quarter listed equities commission figures. Options commissions, while quite stable through the year, were nonetheless off a steep 14.7% from 1980. The increases in trading, margin interest, and other-related revenues are all closely tied to the level of interest rates. So, indirectly, is the increase in account supervision revenues, which include management fees charged in-house money market funds.

Underwriting revenues were up 18.4% over 1980. More strikingly, they doubled between 1979 and 1981. This rate of increase exceeds that in either corporate or municipal offerings over the period; the likeliest explanation is that equity offerings and the new issue business, in particular, increased in relative importance.

The decline in commodities revenues relates to the fall in commodities prices over the course of 1981. It should be remembered, however, that these figures represent a decline off a base that had risen rapidly.

The increase in other-unrelated revenues is particularly noteworthy. To the extent that "financial supermarket"-type services are reported within the FOCUS framework, they are in this number. The rapid rise of these revenues reflects efforts to diversify outside securities products and services.

## The Agency Equity Business

Exchange volume is traditionally a key determinant of industry profitability. Fluctuations in volume can be used, with adjustment for operating leverage, to predict profit fluctuations. It increasingly happens, though, that record volume does not ensure record profits. The retail/institutional breakdown of volume is also of great importance, for the institutional brokerage business is known to be less profitable. The latter part of 1981 witnessed a marked cooling of the retail market enthusiasm which had surfaced early in 1980. Money market funds, which by year-end 1981 had ballooned to $184 billion, were one symptom of this retail hesitancy. The slowing down of the new issues business was another such symptom, large blocks as a percentage of NYSE volume, a third. Shown below are figures on NYSE volume and 10,000 share blocks.

Table 5

| | NYSE Average Daily Share Volume (millions of shares) | Large Blocks as a % of NYSE Volume |
|---|---|---|
| 1Q 1980 | 47.5 | 30.0 |
| 2Q 1980 | 36.0 | 30.2 |
| 3Q 1980 | 47.6 | 27.8 |
| 4Q 1980 | 48.4 | 29.0 |
| 1Q 1981 | 47.5 | 29.5 |
| 2Q 1981 | 49.7 | 32.6 |
| 3Q 1981 | 44.3 | 31.7 |
| 4Q 1981 | 46.0 | 33.4 |

As long ago as 1969, the NYSE Public Transaction Study revealed that institutional volume exceeded retail. The most recent Public Transaction Study, covering the fourth quarter of 1980, showed for the first time that member trading also exceeded the retail share. This phenomenon obviously weakens the relationship between exchange volume and commission revenues. Shown below are

figures on member trading as a percentage of NYSE volume. It is interesting to note that, as of the first quarter of 1982, this figure had gone as high as 27.5%.

Table 6

Member Trading as a Percentage of NYSE Volume

| | | | |
|---|---|---|---|
| 1976 | 23.2 | 1979 | 25.2 |
| 1977 | 23.7 | 1980 | 26.6 |
| 1978 | 24.6 | 1981 | 26.7 |

NYSE data cannot provide a complete sense of the industry's equity business, for conditions on the other markets are influenced by a somewhat different set of variables. NYSE stocks tend to have a higher institutional profile than other markets. In the fourth quarter of 1980, the institutional/retail breakdown of NYSE public volume was 64.9%/35.1%. (It should be remembered, too, that the fourth quarter of 1980 was a period of unusually heavy retail trading.) That breakdown for the other markets surveyed was 32.4%/67.6%. A look at Amex and NASDAQ volume, therefore, gives a better sense of retail activity. Because trends evident in late 1981 became more pronounced in early 1982, data covering that period is included in the table below.

Table 7

Average Daily Share Volume
(millions of shares)

| | 1Q 1980 | 1Q 1981 | 1Q 1982 |
|---|---|---|---|
| NYSE | 47.5 | 47.5 | 51.8 |
| Amex | 8.0 | 5.9 | 4.9 |
| NASDAQ | 24.7 | 30.9 | 26.9 |

The data above suggest an increase in institutional market share over the two year period, as did the NYSE large block figures discussed above. More precisely, they indicate a reversal of the retail revival that got under way in late 1979.

## Trading and Investment

Trading profits are one of the industry's key bottom line determinants. The use of financial futures has shielded firms somewhat from increased interest rate volatility, but the third quarter 1981 downturn was clearly trading-related, as shown in the figures below. The FOCUS Report's inclusion of accrued interest in reported trading revenues tends to obscure the profitability of trading, but the figures' general drift is clear. Accrued

interest is netted out for investment profits, which are therefore shown separately below. Deficit-related market fears show up in the negative third quarter investment profits figure, while the institutional slant of the fourth quarter earnings rebound is visible in the magnitude of both fourth quarter trading profits and investment profits.

Table 8

Securities Industry Trading & Investment Profits, 1981
(millions of dollars)

| | 1Q | 2Q | 3Q | 4Q |
|---|---|---|---|---|
| Trading Profits | $1,111 | $937 | $839 | $1,356 |
| Investment Profits | 256 | 126 | (16) | 209 |

The numbers above raise some question as to why the retail sector of the industry should have suffered a greater third quarter decline than did institutional firms. The answer lies partly in agency business conditions and partly in the composition of trading revenues, which are shown below.

Table 9

Components of Trading Revenue, 1981
(millions of dollars)

| | 1Q | 2Q | 3Q | 4Q |
|---|---|---|---|---|
| OTC Stocks | $ 163 | $197 | $ 88 | $ 161 |
| Debt Securities | 723 | 655 | 634 | 1,071 |
| Other | 225 | 85 | 117 | 124 |
| Total | 1,111 | 937 | 839 | 1,356 |

The third quarter drop is partly concealed by high accrued interest on debt securities. The decline in revenues for OTC stocks is noteworthy; these are a retail investment vehicle and any decline in them hits wirehouses and Regionals more heavily than the Large Investment Bankers. The OTC trading numbers are more reliable in reflecting "real" trends in trading profits than those for debt, since accrued interest is not a factor.

The securities industry's greater success in trading, noted over the past three years, has been achieved in spite of far greater market volatility and net long positions. It is widely attributed to the rise in the use of financial futures, which provides increased flexibility in hedging interest rate risks.

Table 10

Financial Futures Trading Volume
(thousands of contracts)

| | 1979 | 1980 | 1981 |
|---|---|---|---|
| Financial Futures Contracts Traded | 5,607 | 12,469 | 22,864 |
| As a Percentage of All Futures Contracts Traded | 7.4 | 13.5 | 23.2 |

Source: Futures Industry Association

## Underwriting

Since October 1979, conditions in the U.S. capital markets, and particularly in the debt markets, have been heavily influenced by "market windows" that appear and disappear with striking suddenness. Under certain circumstances, the need for equity capital or requirements of municipal issuers are less responsive to changes in interest rates than is the case for corporate issuers of long-term debt who can often delay projects or switch to issuing short-term paper until interest rate costs turn relatively more attractive. Shown below are monthly figures, for 1981, on corporate debt, equity, municipal offerings and interest rates.

Table 11

| | Corporate Debt | Corporate Equities | Municipal | Aaa Corporate Rate |
|---|---|---|---|---|
| January | $2,992 | $1,561 | $2,573 | 12.81 |
| February | 2,759 | 858 | 2,890 | 13.35 |
| March | 3,651 | 1,732 | 3,694 | 13.33 |
| April | 5,534 | 1,910 | 5,081 | 13.88 |
| May | 2,452 | 1,878 | 3,357 | 14.32 |
| June | 6,333 | 3,118 | 4,921 | 13.75 |
| July | 2,831 | 1,177 | 3,255 | 14.38 |
| August | 972 | 705 | 3,087 | 14.89 |
| September | 2,583 | 634 | 3,539 | 15.49 |
| October | 3,207 | 848 | 3,625 | 15.40 |
| November | 8,793 | 1,164 | 5,035 | 14.22 |
| December | 4,906 | 1,141 | 5,072 | 14.23 |

Source: The Bond Buyer; Investment Dealers' Digest

Issuers are more concerned, increasingly, with relative than with absolute levels of interest rates. A modest drop in rates, or the belief that rates will soon be higher, can therefore produce a stampede of market-bound issuers. April, June and November were the big window months. The virtual drying up of the corporate bond market in August reflects anxieties over the Federal deficit; the equity markets were similarly hit. The importance of equity offerings to underwriting revenues is seen in the second quarter. Although total debt (corporate and municipal) issued was about $3 billion more in the fourth quarter, equity offerings were $3.8 billion greater in the second quarter. That is the major explanation for the Spring quarter's underwriting revenues reaching almost $500 million. Indeed, two-thirds of the value of equity offerings in 1981 were issued during the first half of last year.

Table 12

Underwriting Revenues, 1981
(millions of dollars)

| 1Q | 2Q | 3Q | 4Q |
|---|---|---|---|
| 351 | 493 | 323 | 406 |

## Other Related Revenues

Other revenues related to the securities business amounted to just under $3 billion, or 15% of gross revenues. This is something of a catch-all in the FOCUS reporting framework. The largest components are believed to be M&A fees and the interest earned on reverse repurchase agreements, activities for which the prerequisites are, respectively, corporate finance expertise and institutional distribution. It is not surprising, therefore, that the Large Investment Bankers accounted for a 44.9% share of these revenues, as compared to a 28.5% share of gross. In 1981, corporate merger activity was at a record level, with a record 1,126 transactions valued at $82.6 billion. For several firms, the M&A area was the brightest aspect of late 1981.

The business of matching repurchase agreements and reverse repurchase agreements is an arbitrage activity stimulated by high interest rates. At year-end 1981, reverse repos amounted to $42.4 billion, or 35% of total assets while repos amounted to $51.7 billion. Almost as much as M&A work, this business is dominated by the Large Investment Bankers.

## Expenses

The industry's expense picture during 1981 was very much dominated by interest. It was one of the few expenses that increased between the second and third quarters, and it had the highest year-to-year rate of increase. As has been noted, the

cost-of-funds advantage retail firms gain from free credit balances is increasingly jeopardized by innovative customer services. The modest increase in RR Compensation and the drop in Floor Brokerage & Clearance say less about cost control than they do about the level and makeup of volume.

Table 13

Securities Industry Expense Breakdown*, 1981
(millions of dollars)

| | 1Q | 2Q | 3Q | 4Q | Full Year 1981 | Percentage Change 1981-1980 |
|---|---|---|---|---|---|---|
| Floor Brokerage & Clearance | $ 186 | $ 193 | $ 173 | $ 179 | $ 726 | (4.0)% |
| RR Compensation | 789 | 851 | 773 | 927 | 3,339 | 9.5 |
| Clerical & Administrative Employee Expenses | 746 | 767 | 714 | 875 | 3,102 | 21.9 |
| Communications | 242 | 266 | 276 | 303 | 1,085 | 29.6 |
| Occupancy & Equipment | 151 | 165 | 165 | 183 | 663 | 28.2 |
| Promotional Costs | 100 | 112 | 108 | 138 | 457 | 31.7 |
| Interest Expense | 1,353 | 1,335 | 1,501 | 1,497 | 5,683 | 65.0 |
| Losses in Error Accounts and Bad Debts | 40 | 39 | 38 | 39 | 154 | (24.9) |
| EDP Equipment Costs | 46 | 46 | 63 | 63 | 217 | 39.1 |
| Regulatory Fees & Expenses | 18 | 19 | 20 | 25 | 80 | 21.2 |
| Partners' & Voting Stockholders' Salaries | 161 | 165 | 145 | 194 | 664 | 17.1 |
| Other Expenses | 358 | 372 | 324 | 410 | 1,481 | 4.1 |
| TOTAL | $4,190 | $4,330 | $4,300 | $4,833 | $17,651 | 28.3% |

* Numbers may not add due to rounding.

The largest decrease was in the Error Accounts figure, sign of an operational house put in order, or of retail slowdown, or both. Less encouraging was the rate of increase in the so-called "fixed" expenses -- Clerical & Administrative, Communications, and Occupancy & Equipment -- far exceeding 1981 CPI increases and the increase in interest-deflated gross revenues. As we have noted before, this rise in overhead is a serious concern for an industry with so volatile a revenue stream. For firms involved in a retail business, the growth in overhead expenses is a particular problem.

Rates of increase over a five-year span, shown in the table below, are also revealing. This table shows that fixed costs have become more of a problem in the past two years. The meteoric rise in trading volume that began in April 1978 shows up in the RR Compensation figures. Most noteworthy and most consistent is the growth in interest expense. Interest rates, and the intermediation activities of broker/dealers, were both on a steady upward trend throughout most of the period covered in this table.

Table 14

Securities Industry Revenues and Expenses
Rate of Growth, 1977-1981
(1977 = 1.00)

| | 1977 | 1978 | 1979 | 1980 | 1981 |
|---|---|---|---|---|---|
| Gross Revenues | 1.00 | 1.31 | 1.67 | 2.38 | 2.94 |
| Total Expenses | 1.00 | 1.28 | 1.60 | 2.17 | 2.79 |
| Floor Brokerage & Clear. | 1.00 | 1.33 | 1.39 | 1.62 | 1.56 |
| RR Compensation | 1.00 | 1.29 | 1.52 | 2.43 | 2.66 |
| Clerical & Admin. | 1.00 | 1.13 | 1.39 | 1.90 | 2.32 |
| Communications | 1.00 | 1.10 | 1.28 | 1.59 | 2.06 |
| Occupancy & Equipment | 1.00 | 1.06 | 1.20 | 1.45 | 1.86 |
| Promotional | 1.00 | 1.06 | 1.41 | 1.97 | 2.59 |
| Interest | 1.00 | 1.63 | 2.57 | 3.30 | 5.45 |
| Error Account | 1.00 | 1.85 | 2.39 | 5.00 | 3.75 |

## The Regulatory Scene

Throughout the year, important economic and regulatory factors were at work altering the status quo. Foremost among these was interest rate behavior, with its dire implications for long-term financing in general and especially for thrifts. As is frequently noted, the thrift industry is the weakest link in the financial system. The thrifts' present straits are largely responsible for a sweeping reappraisal of the whole financial regulatory scheme. The likely outcome of this reexamination is still not clear.

Money market funds are an important product of these same interest rate conditions. Their explosive growth, from $11 billion in assets at the start of 1979 to $184 billion at the end of 1981, is sometimes depicted as having been achieved at the expense of the thrifts. In fact, the thrifts are victims not of the money market funds but of Regulation Q and a serious asset-liability mismatch. Broker/dealers' high visibility in money fund promotion has given a great regulatory significance to this quarrel.

The most innovative and controversial use to which broker/dealers have put these funds is in the asset management account, which links a money market fund investment to a brokerage margin

account and a zero-balance bank account. The result is a vast simplification of a customer's financial transactions. Availability to customers of an asset management account is now considered by some among the most formidable competitive weapons in the retail securities business. Ironically, it is believed also to be among the least profitable, since it imposes heavy administrative burdens and severely restricts a firm's ability to utilize float. This is an interesting case of competitive forces pulling an industry in a direction where there are some mixed feelings. Some Regional firm managements question their own ability to offer a comparably expanded product line; joint ventures and mergers are likely options. The tendency towards broader financial product lines and larger organizations is very pronounced.

Broker/dealers are not alone in seeking to offer a broader range of financial services. During the year, three federally-chartered S&Ls sought (and have since received) Federal Home Loan Bank Board approval of a stock brokerage joint venture. This raised important questions concerning both the Glass-Steagall Act and the differences between different kinds of depository institutions. The thrifts' Federal regulators have argued consistently for expansion of asset powers as an inexpensive means of easing the thrifts' plight. Without underplaying the significance of this thrift foray into brokerage, many observers nonetheless doubt that it could become a serious competitive challenge. This is because the thrifts' depositors, with a heavy passbook orientation, are somewhat removed from the upscale retail market broker/dealers now seek. Its greatest significance is in the possibility that commercial bank interests may cite the precedent in seeking regulatory approval of similar undertakings.

The large money center banks, having long chafed at restrictions on interstate banking and securities activities, are increasingly outspoken in the new climate of deregulation. In October 1981, the Administration put forward a proposal that would allow banks to underwrite municipal revenue bonds and sponsor mutual funds through arms'-length affiliates subject to the same regulatory and tax treatment as are broker/dealers. From the securities industry's viewpoint, these were the most acceptable proposals yet in the quest for a "level playing field." The recent Drysdale debacle may have increased the appeal of this proposal to other government officials and staff.

## Conclusion

The industry's 1981 earnings performance, if down from 1980's level, was impressive nevertheless. A recurring theme -- indeed, the recurring theme -- of this publication is the cyclicality of the securities business. Reviewing 1981 data, one becomes aware not only of a possibly inevitable falling off from a great cyclical upswing but also of business, or at least securities industry, cycles within 1981 itself. The end of the year saw institutional firms again operating very profitably, while retail firms saw their earnings fall far below recent levels.

Ever since 1979, the securities industry's performance under fire has been widely noted and praised. The recent behavior of interest rates has not eliminated the need for financing. Rather, it has increased the need for financing expertise, something equally in demand in underwriting, M&A, and principal lines of business. Under these same chaotic conditions, equities resumed, if briefly, their old place as the ultimate inflation hedge. Fears that this revival may prove to have been short-lived are at present the cause of great concern.

The industry now faces considerable uncertainty as to who will be its future customers and competitors. The retail slide of late 1981 and early 1982 has caused market institutionalization to speed up. The equity markets in particular suffer from any retail withdrawal, and most recent mergers have been entered into so as to offer the retail investor more, not fewer, financial services.

The Administration's October 1981 proposals to modify Glass-Steagall, which would permit arms'-length subsidiaries of a bank holding company to underwrite revenue bonds and promote mutual funds, underscore the speed with which the financial structure is changing. At the same time, the great divide between securities firms and Corporate America has been largely bridged. It has never been harder to predict the nature not only of future competition but also of future competitors.

In some quarters, the recent wave of mergers involving Regional firms has been interpreted negatively as the writing on the wall. In fact, it is a far more hopeful sign, for the premiums over book or market attest to the desirability of this industry's customer and client contacts.

Jeffrey M. Schaefer
Senior Vice President and
Director of Research

Timothy Y. Smith
Assistant Director
of Research

# SECURITIES INDUSTRY STATISTICS

VOLUME

| | March 1982 | YEAR-TO-DATE 1982 | March 1981 | YEAR-TO-DATE 1981 | % CHG. Y-T-D 1982-1981 |
|---|---|---|---|---|---|
| AVERAGE DAILY SHARE VOLUME ON | | | | | |
| NYSE (MILS.)* | 55.2** | 51.6 | 53.4 | 47.3 | 9.1% |
| AMEX (MILS.)* | 4.3 | 4.4 | 5.7 | 5.5 | (20.0) |
| NASDAQ (MILS.)* | 26.6 | 27.4 | 31.1 | 30.9 | (11.3) |
| REGIONAL EXCHANGE (MILS.)* | 7.7 | 7.2 | 6.5 | 5.7 | 26.3 |
| DOLLAR VALUE OF SHARES TRADED ON | | | | | |
| NYSE (MILS.) | 34,559 | 91,687 | 40,383 | 102,402 | (10.5) |
| AMEX (MILS.) | 1,183 | 3,730 | 2,247 | 6,613 | (43.6) |
| ODD-LOT SHARES PURCHASED ON NYSE (THOUS.) | 5,444 | 14,872 | 6,142 | 16,686 | (10.9) |
| ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.) | 10,853 | 28,323 | 14,259 | 35,765 | (20.8) |
| NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED | 37.9** | 36.7 | 30.0 | 29.6 | 24.0 |
| CONTRACTS TRADED (THOUS.) | | | | | |
| CBOE OPTIONS | 6,360 | 17,789 | 4,988 | 13,855 | 28.4 |
| AMEX OPTIONS | 3,030 | 8,750 | 3,221 | 8,292 | 5.5 |
| COMMODITY | 9,560 | 24,958 | 8,269 | 23,818 | 4.8 |

* *MONTHLY AVERAGE*
* New high

## YIELDS

(MONTHLY AVERAGES)

| | April 1982 | April 1981 | Basis Point Chg. |
|---|---|---|---|
| BOND BUYER INDEX (20 BOND) | 12.58 | 10.62 | 1.96 |
| CORPORATE BOND YIELDS (MOODY'S) | | | |
| Aaa CORPORATE | 14.46 | 13.88 | 0.58 |
| Baa CORPORATE | 16.78 | 15.56 | 1.22 |
| RATIO Aaa CORPS. TO Baa CORPS. | 0.86 | 0.89 | (.03) |
| MUNICIPAL BOND YIELDS (MOODY'S) | 11.66 | 9.78 | 1.88 |

## PRICES

(END OF MONTH)

| | May 1982 | May 1981 | % Change Yr.- to - Yr. |
|---|---|---|---|
| DOW JONES INDUSTRIALS | 819.54 | 991.75 | (17.4%) |
| STANDARD & POOR'S 500 | 111.88 | 132.59 | (15.6%) |
| NYSE COMPOSITE | 64.54 | 76.99 | (16.2%) |
| AMEX MARKET VALUE INDEX | 271.23 | 377.00 | (28.1%) |
| VALUE LINE COMPOSITE | 124.88 | 156.96 | (20.4%) |
| NASDAQ COMPOSITE | 178.54 | 223.47 | (20.1%) |

## UNDERWRITING
## (DOLLARS IN MILLIONS)

| | March 1982 | Yr.-to-Date 1982 | March 1981 | Yr.-to-Date 1981 | % Change Mar'82-Mar'81 | % Change Yr.-to-Date |
|---|---|---|---|---|---|---|
| **CORPORATE FINANCING** (Gross New Issues) | | | | | | |
| Total | 6,790 | 11,044 | 5,384 | 13,554 | 26.1 | (18.5) |
| Competitive | 307 | 436 | 392 | 1,273 | (21.7) | (65.8) |
| Negotiated | 6,483 | 10,608 | 4,992 | 12,281 | 29.9 | (13.6) |
| Common Stock | 812 | 1,901 | 1,382 | 3,297 | (41.2) | (42.3) |
| # Of Common Stock Issues | 40 | 115 | 73 | 201 | (45.2) | (42.8) |
| Preferred Stock | 200 | 516 | 350 | 854 | (42.9) | (39.6) |
| # Of Preferred Stock Issues | 4 | 12 | 4 | 15 | -- | (20.0) |
| Corporate Debt | 5,778 | 8,626 | 3,652 | 9,403 | 58.2 | ( 8.3) |
| # Of Corporate Debt Issues | 50 | 83 | 33 | 98 | 51.5 | (15.3) |
| **MUNICIPAL FINANCING*** (Gross New Issues) | April 1982 | Yr.-to-Date 1982 | April 1981 | Yr.-to-Date 1981 | % Change Mar'82-Mar'81 | % Change Yr. - Yr. |
| Total | 9,586 | 30,564 | 6,963 | 21,820 | 37.7 | 40.1 |
| Notes | 3,102 | 11,285 | 1,881 | 7,579 | 64.9 | 48.9 |
| Bonds | 6,484 | 19,279 | 5,082 | 14,241 | 27.6 | 35.4 |
| # of Bond Issues | 406 | 1,363 | 385 | 1,223 | 5.5 | 11.4 |
| Negotiated Bonds | 4,440 | 13,040 | 3,180 | 8,120 | 39.6 | 60.6 |
| Revenue Bonds | 4,060 | 12,490 | 3,500 | 9,290 | 16.0 | 34.4 |

*Preliminary Figures

MUTUAL FUNDS
(DOLLARS IN MILLIONS)

| | March 1982 | Year-to-Date 1982 | March 1981 | Year-to-Date 1981 | %Change, Y-T-D '82 to Y T-D'81 |
|---|---|---|---|---|---|
| NET SALES* | 330.4 | 982.0 | 122.0 | 463.0 | 112.1 |
| NET PURCHASE OF COMMON STOCK* | 394.7 | (401.3) | 273.7 | 507.0 | -- |
| NET PURCHASE OF OTHER SECURITIES* | (40.0) | 207.6 | 157.8 | 314.0 | (33.9) |
| MUTUAL FUND CASH POSITION | 14.3 | -- | 9.2 | -- | -- |

*EXCLUDES MONEY MARKET, MUNICIPAL BOND AND OPTION FUNDS

MARGIN DEBT

| | April 1982 | April 1981 | % Change Mar.'82-Mar.'81 |
|---|---|---|---|
| MARGIN DEBT OUTSTANDING ($MILS) | 11,950 | 14,630 | (18.3) |
| NET CHANGE IN MARGIN DEBT ($MILS) | (2,680) | 3,490 | -- |
| % OF ACCOUNTS WITH EQUITY UNDER 40% | 10% | 13% | -- |

* ALL TIME HIGH

FINANCIAL DATA FOR NYSE FIRMS DOING A PUBLIC BUSINESS
(MILLIONS OF DOLLARS)

| | First Quarter 1982 | Yr.-to-Date 1982 | First Quarter 1981 | Yr.-to-Date 1981 | % Change 1st Q.1982 1st Q.1981 | % Change Yr.-to-Date 1982-1981 |
|---|---|---|---|---|---|---|
| REVENUE | | | | | | |
| SECURITIES COMMISSION INCOME | 1,157 | 1,157 | 1,373 | 1,373 | (15.7%) | (15.7%) |
| REALIZED AND UNREALIZED GAIN OR LOSS IN TRADING AND INVESTMENT | 1,072 | 1,072 | 1,366 | 1,366 | (21.5%) | (21.5%) |
| PROFIT OR LOSS FROM UNDERWRITING AND SELLING GROUPS | 360 | 360 | 350 | 350 | 2.9% | 2.9% |
| TOTAL REVENUE | 4,535 | 4,535 | 4,861 | 4,861 | ( 6.7%) | ( 6.7%) |
| TOTAL EXPENSES | 4,365 | 4,365 | 4,193 | 4,193 | 4.1% | 4.1% |
| NET INCOME BEFORE TAXES | 170 | 170 | 668 | 668 | (74.6%) | (74.6%) |
| PERCENT OF FIRMS SHOWING LOSS | 42.7% | 42.7% | 16.2% | 16.2% | --- | |

## RECENT INTERESTING READING AND STATISTICAL MATERIAL

| ITEM | DESCRIPTION | SOURCE |
|---|---|---|
| Statement of the Securities Industry Assoc. Before the Committee on Ways & Means re: "Tax Compliance Act of 1982" | Written submission on proposal which would require gross proceeds reporting by all brokers in capital assets and expanded interest reporting. | Order from:<br>SIA<br>Research Department<br>20 Broad St., 19th Fl.<br>New York, N.Y. 10005 |
| SIA's Corporate Underwriting Committee's Submission on Temporary Rule 415 | Written submission on 415 and, more broadly, the entire phenomenon of rapid distributions and "bought" deals. | Order from:<br>SIA<br>Research Department<br>20 Broad St., 19th Fl.<br>New York, N.Y. 10005 |
| "The Impact of Rule 415" | An overview of Rule 415 -- positions taken by interested parties before the Rule was adopted on a temporary basis, its relationship to preceding efforts by the SEC to integrate and simplify disclosure requirements and some anticipated consequences. | Euromoney<br>May 1982 |
| Competition in the Eighties | Complete transcript of Trends Conference proceedings. Topics include: emerging regulatory/legislative and economic changes, micro and macro determinants of industry profitability, the changing customer base and strategies for the eighties. | Order from:<br>SIA<br>Research Department<br>20 Broad St., 19th Fl.<br>New York, N.Y. 10005<br>Price per copy: $30.00 |
| Shareownership 1981 | Findings of Shareownership Survey conducted by the NYSE -- national shareowner population, median portfolio value and breakdown by educational level, occupation and region. | Order from:<br>NYSE<br>11 Wall Street<br>New York, N.Y. 10005<br>Charge per copy: $3.00<br>(plus sales tax of $0.25 if in N.Y.) |

| ITEM | DESCRIPTION | SOURCE |
|---|---|---|
| The NASDAQ Securities Fact Book 1981 | Daily and monthly volume, most active stocks, market value, performance of NASDAQ securities, policing, NASDAQ securities in the NMS, etc. | Order from:<br>National Assoc. of Securities Dealers<br>1735 K Street, N.W.<br>Washington, D.C. 20006<br>Single copy free |
| Pension Facts 1981 | Compendium of data on private and government-administered pension and retirement plans, historical trends in growth rates and a review of relevant provisions in ERTA and recommendations of the President's Commission on Pension Policy. | Order from:<br>American Council of Life Insurance<br>Information, Reference & Statistical Svcs.<br>1850 K Street, N.W.<br>Washington, D.C. 20006<br>Single copy free |
| 1981 Life Insurance Fact Book | Useful reference source on the insurance industry. Text, charts and tables on life insurance ownership, benefit payments, income of insurance companies, taxes, reserves, assets, etc. | Order from:<br>American Council of Life Insurance<br>Information, Reference & Statistical Svcs.<br>1850 K Street, N.W.<br>Washington, D.C. 20006<br>Single copy free |
| 1982 Mutual Fund Fact Book | Extensive overview of mutual fund industry -- historical background, recent trends in activity by type of fund, results of a shareholder survey, etc. Text supplemented with tables and charts. | Order from:<br>ICI<br>1775 K Street, N.W.<br>Washington, D.C. 20006<br>Single copy free |

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Securities Industry Trends

AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

Vol. VIII No. 5 A8825-1 9/9/82 August 27, 1982

# MAJOR DETERMINANTS OF FOREIGN PORTFOLIO INVESTMENT

## HIGHLIGHTS

1. Although foreign investors from various countries respond differently to trends in macroeconomic variables, investment flows from individual European countries are all strongly correlated with aggregate foreign investment and, particularly, capital flows from Europe. In other words, like institutional investors in the U.S., foreign investors from different countries appear to develop "similar buy and sell attitudes" toward U.S. equities.

2. Simple correlations show that, of the major foreign investors, the Mideast oil-exporting nations evidenced little, if any, consistency with investment patterns from other foreign countries. The correlations indicate that the recent explosion in stock prices probably attracted foreign investors, particularly U.K. money managers. This is confirmed by an informal telephone poll recently conducted with several member organizations.

3. In 1980 and 1981, net foreign investment in U.S. equities reached unprecedented levels of $5.4 billion and $5.8 billion, respectively. While foreign investment in the U.S. has grown to significant levels over the past decade, the trend has been subject to volatile swings. For example, on a quarterly basis, net purchases varied from a low of $(165) million in the fourth quarter of 1974 to a high of $2.9 billion in the second quarter of 1981.

4. There are several gauges that indicate the importance of foreign investment to the supply of equities offered in the primary and secondary markets. Measured as a percentage of net purchases by U.S. institutional investors plus foreign investors, foreign investment accounted for over a quarter of institutional net buying of common stocks in 1980 and 1981. Moreover, since 1975, foreign purchases have averaged 37.1% annually of the value of new equity issues coming to market.

5. From time to time, certain transitory variables can be identified that cause a temporary spurt or slack in foreign capital flows. The Mideast oil surplus, the French national elections in 1981, and the lifting of U.K. exchange controls in 1979, all played a pivotal role in influencing foreign flows into the U.S. equity market.

## Introduction

Foreign investors, primarily Europeans, became major buyers of U.S. equities starting in 1968. While the trend towards increased foreign investment has by no means been without interruption over the past years, the amount of foreign investment overall has grown to significant proportions. Specifically, after reaching $2.8 billion in 1973, foreign investment in U.S. equities plunged to $540 million in 1974, jumped to $4.7 billion in 1975, averaged $2.4 billion over the next four years, and soared to record amounts of $5.4 billion and $5.8 billion, respectively, in 1980 and 1981. The ebb and flow of foreign investment is influenced heavily by trends in such macroeconomic variables as economic growth, tax policy, stock prices, interest rates, and foreign exchange movements. From time to time, other variables, some quite temporary in nature, cause a spurt or slack in foreign capital flows. In essence, there may be three components to the foreign investor's decision: major economic determinants, identifiable transitory variables, and other non-quantifiable factors.

The U.S. Treasury Department is the primary source of data on foreign capital flows into the U.S. Periodically, the Treasury publishes a benchmark survey on foreign portfolio investment in the U.S. In the latest study,[1] the Treasury cited a variety of factors as determining the "form" of foreign portfolio investment in the U.S. Among these factors, were:

> "The willingness of different types of foreign investors to hold U.S. dollar denominated assets issued in the United States as determined chiefly by a) the yield on and the safety of possible investments here relative to alternative investment opportunities in other countries, and b) short- and long-term investment objectives, and the strategies and tactics of the particular foreign investor."

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[1] Report on Foreign Portfolio Investment in the United States as of December 31, 1978, Department of the Treasury, Office of the Secretary, December, 1980.

Treasury also found that there was some correlation between foreign investment and the location of the foreign investor.

> "Foreign holdings of all types of U.S. portfolio assets were spread throughout the world, with the most significant volumes centered in regions generally exhibiting one or more of three characteristics:
>
> 1. Countries with long standing and sizeable commercial relationships with the United States;
>
> 2. Countries with well developed financial services industries, including, in some cases, favorable tax treatment of foreigners and strict protection of the privacy and confidentiality of investors;
>
> 3. Countries whose currencies are used as an international medium of exchange or store of value."

In Treasury's earlier survey,[2] the basic reasons for foreign investment in the United States were elaborated on.

> "Basically foreigners invest money in the United States in order to maximize the return on their investment, either in terms of income or capital growth, while at the same time reducing risk by portfolio diversification. The possibilities for long-term capital growth, the avoidance of economic and political risk in other countries, the size and liquidity of U.S. capital markets, the protection of investors under the regulations of the Securities and Exchange Commission and U.S. law in general, ample diversity of investment choices by industry, and sales efforts of American broker/dealers are among the major factors stimulating foreign investment in the United States."

## Level of Foreign Portfolio Investment

The bull market of the 1960's together with the elimination of capital gains taxes on foreign investors opened the eyes of overseas money managers to the desirability of U.S. stocks. Table I shows the pattern of net buying since 1970.

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[2] Report to the Congress on Foreign Portfolio Investment in the United States, Unites States Treasury Department, Office of the Secretary, August, 1976.

Table I

Net Foreign Equity Purchases
($millions)

| Year | Net Purchases |
|---|---|
| 1970 | $ 626 |
| 1971 | 731 |
| 1972 | 2,188 |
| 1973 | 2,790 |
| 1974 | 540 |
| 1975 | 4,678 |
| 1976 | 2,753 |
| 1977 | 2,675 |
| 1978 | 2,423 |
| 1979 | 1,679 |
| 1980 | 5,418 |
| 1981 | 5,761 |
| 1/82-5/82 | 1,608 |

Source: U.S. Treasury Bulletin

Chart I indicates the quarterly trend in foreign net purchases since the first quarter of 1975. It is clear that since 1975, the foreign appetite for U.S. stocks has been large. Until the third quarter of 1978, foreigners were consistent net buyers of U.S. equities. In that quarter, foreigners were net sellers of U.S. equities for the first time since the 1973-74 bear market bottom was reached in the fourth quarter of 1974. Despite a relatively healthy stock market during the third quarter of 1978, prospects for the dollar were pessimistic. Indeed, the Administration announced a dollar support package in November of that year. The level of fourth-quarter foreign investment indicated renewed interest in U.S. equities. However, the dollar depreciated against most key currencies and the major stock market indices made only minimal gains in 1978, contributing to a dampened level of foreign activity.

In 1979, foreign investment in U.S. equities continued to wane, declining to its lowest level since 1974 -- $1.8 billion. The year was marked by several international events that depressed foreign investment. At the beginning of the year, Iran imposed a temporary suspension of oil exports. At first blush, the political turmoil in Iran actually favored the dollar in that the increase in spot oil prices generated additional demand for dollars and the U.S. was considered to be in a better position to cope with a short-term oil crisis.[3] The dollar held its own in

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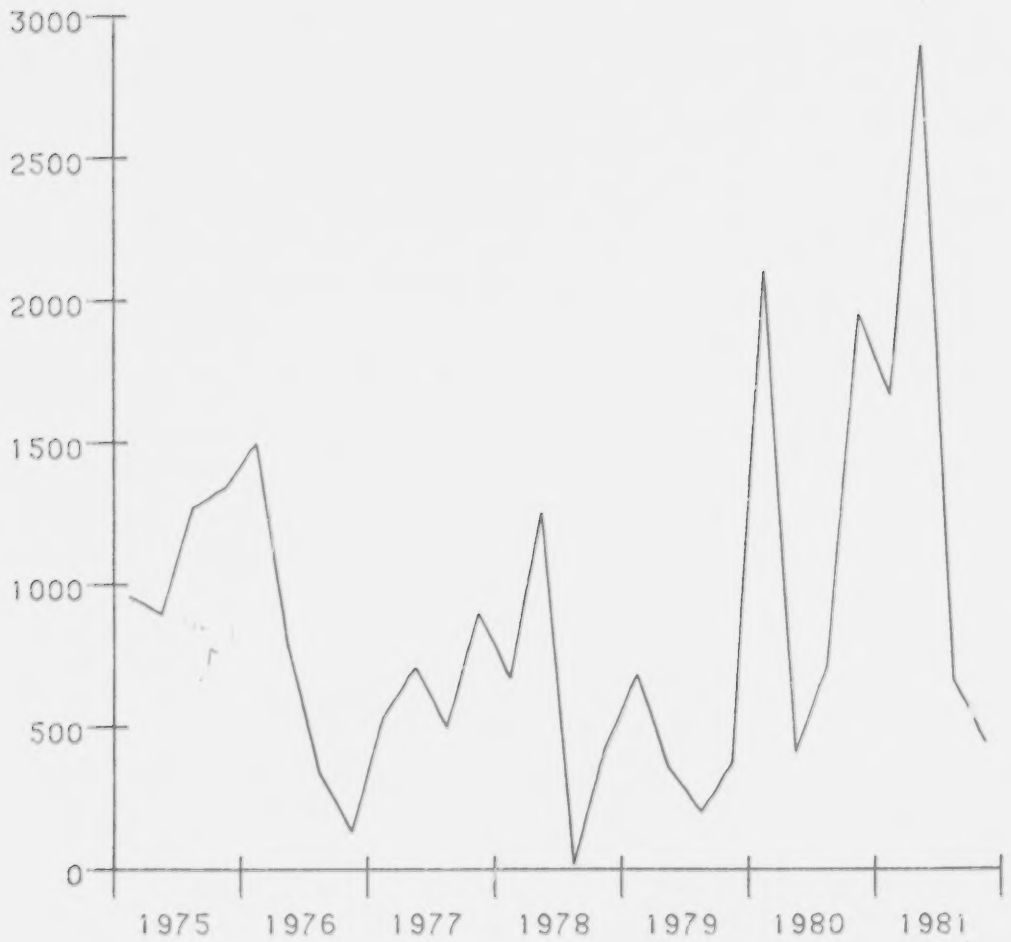
[3] "Treasury and Federal Reserve Foreign Exchange Operations," Federal Reserve Bulletin, September 1979.

Chart I

Quarterly Net Foreign Investment
in U.S. Equities
($ millions)



the first quarter and foreign investment in U.S. equities was at its 1979 quarterly high. As the year progressed, however, surging oil prices generated rapidly rising inflation as well as concern over the effectiveness of U.S. policy to implement a comprehensive energy program. The dollar fell precipitously, and gold began its astronomical climb as investors worldwide searched for ways to tie capital to hard assets instead of paper money. In October, the Federal Reserve initiated a series of policy measures aimed at strengthening the dollar. However, the dollar underwent another round of weakness precipitated by international events. In November, the Iranian militants seized the U.S. embassy and, later in the year, the Soviet Union invaded Afghanistan. On balance, the dollar depreciated against every major currency except the yen. Even though stock market indices showed healthy gains, the falling dollar and uncertain economic conditions reduced foreign interest in U.S. equities.

In 1980 and 1981, foreign investment in U.S. equities reached unprecedented levels. Although undergoing wide and generally unpredictable swings, the dollar scored decisive gains against all major currencies. On the other hand, the stock market, while gaining impressively in 1980, fared poorly in 1981. In tracing foreign investment on a quarterly basis in recent years, the strength or weakness of the dollar was generally the main determinant, overshadowing other considerations.

Through May 1982, foreign investment in U.S. equities totaled $1.6 billion, a somewhat depressed level compared with 1980 and 1981 but substantial nevertheless. The bulk of net purchases, $1.2 billion, stemmed from Europe, mainly the U.K. The dollar advanced against all major currencies over the period, with gains ranging from 4.5% against the West German mark to 10.6% against the Swiss franc. However, the U.S. stock market remained in the doldrums and signs of economic recovery were nil.

## Significance of Foreign Investment

The extent to which U.S. equity markets have been affected by foreign inflows in recent years can be gauged by measuring total foreign net purchases as a percentage of total netpurchases by major institutional investors plus foreign investors. While this percentage peaked in 1975 at over 40%, the ratio in recent years is still impressive. Foreign investors accounted for over a quarter of institutional net buying of common stocks in 1980 and 1981, as their level of buying reached record levels of $5.4 billion and $5.8 billion, respectively.

Table II

Relative Importance of Foreign to Institutional Purchases of U.S. Equities

| | Total Institutional 1/ & Foreign Net Purchases ($ millions) | Foreign Net Purchases (%) |
|---|---|---|
| 1970 | $11,258 | 5.6% |
| 1971 | 18,627 | 3.9 |
| 1972 | 16,566 | 13.2 |
| 1973 | 13,464 | 20.7 |
| 1974 | 5,955 | 9.1 |
| 1975 | 11,394 | 41.1 |
| 1976 | 12,165 | 22.6 |
| 1977 | 7,589 | 35.2 |
| 1978 | 10,776 | 22.5 |
| 1979 | 8,679 | 19.3 |
| 1980 | 20,264 | 26.7 |
| 1981* | 22,167 | 26.0 |

Source: SEC and Commerce Department

1/ Includes private pension funds, mutual funds, life insurance companies, property and casualty insurance companies, and state and local retirement systems.

* Estimated.

Another measure of the impact of foreign investment on U.S. markets is illustrated in Table III, which shows the value of foreign net purchases to new issues in the twelve-year period, 1970-81. Over this period, foreign purchases totaled about $32.3 billion and new issues, $101.0 billion. In effect, foreigners were acquiring almost 32% of the value of new issues coming to market. The peak occurred in 1975, when net purchases by foreigners amounted to almost 70% of the value of new issues. Since 1975, foreign purchases have averaged 37.1% annually of the value of new issues. This comparison is not meant to imply that foreigners purchase only new issues, but rather to show the growing significance of foreign investment to the supply of equities offered in the primary and secondary markets.

Table III

Net Foreign Equity Purchases as a Percentage of New Issues
($ millions)

| Year | Net Purchases | New Issues | % |
|---|---|---|---|
| 1970 | $ 626 | $ 5,463 | 11.5% |
| 1971 | 731 | 11,344 | 6.4 |
| 1972 | 2,188 | 12,978 | 16.9 |
| 1973 | 2,790 | 6,900 | 40.4 |
| 1974 | 540 | 2,646 | 20.4 |
| 1975 | 4,678 | 6,777 | 69.0 |
| 1976 | 2,753 | 8,102 | 34.0 |
| 1977 | 2,675 | 6,615 | 40.4 |
| 1978 | 2,423 | 6,063 | 40.0 |
| 1979 | 1,679 | 5,748 | 29.2 |
| 1980 | 5,418 | 13,341 | 40.6 |
| 1981 | 5,761 | 15,045 | 38.3 |
| Total | $32,262 | $101,022 | 31.9% |

Source: U.S. Treasury and Investment Dealers' Digest.

## Measuring Determinants of Foreign Portfolio Investment

It is difficult to develop a model which expresses portfolio investment as a function of a set of independent variables. Part of this difficulty stems from the impossibility of quantifying expectations in determining levels of such investment. Although domestic investors in the U.S. respond to a narrower range of factors than foreign investors, the set of independent variables that are required to "predict" even domestic levels of investment remain awesome.

In essence, domestic investors' interest in equities will be piqued by rising stock prices, favorable tax policy changes, a healthy economy as evidenced by respectable rates of growth in GNP, P/E ratios, trends in corporate profits and earnings, interest rates, etc. U.S. investors are considerably less responsive to international differentials in these indicators than foreign investors.

The determinants of foreign portfolio investment in the U.S. are even more difficult to quantify. Exchange rate trends and political circumstances are important elements. For example, a prospective investor residing in the U.K. would be more inclined to invest in the U.S. if the dollar were strong viz-a-viz the pound, all other things constant. A rising dollar

translates into more pounds when the dollar-denominated investment is ultimately liquidated. Furthermore, while U.S. investors can assume stability in political developments, this is not the case in many other countries.

The level of foreign portfolio investment in the U.S. may vary in response to indirect relationships between the relevant economic variables. A good deal of OPEC surpluses invested in the U.S. are channeled through the U.K. and Switzerland. Arab investors with accounts in British pounds and Swiss francs will be responsive to changes in pound sterling/$U.S. and Swiss franc/$U.S. exchange rates.

Apart from the sheer quantity of data an empirical analysis of foreign investment in U.S. equities requires, problems in quantifying noneconomic factors arise. Nevertheless, a modest quantitative analysis of foreign investment is useful.

Methodology

Given the data limitations, simple correlations are appropriate in identifying those variables influencing foreign portfolio investment. One would expect aggregate foreign investment to be positively correlated with the trade-weighted exchange rate[4] and flows from individual countries with bilateral exchange rates. Foreign investment should be positively correlated with positive differentials between the U.S. industrial production index and that for OECD countries, rising U.S. stock prices, etc. The results of the correlations are shown in Table IV on the following page.

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[4]Based on average spot rates, weighted by the trade share of major countries in U.S. exports and imports and indexed to May 1970.

Table IV

Correlation Matrix

| | Net Foreign Investment in U.S. Equities From: | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Switzerl. | United Kingdom | West Germany | France | Canada | Total Europe | Middle East* | Japan | All Countries |
| **Countries** | | | | | | | | | |
| Switzerland | 1.00 | | | | | | | | |
| United Kingdom | 0.29 | 1.00 | | | | | | | |
| West Germany | 0.34 | 0.17 | 1.00 | | | | | | |
| France | 0.47 | 0.57 | 0.01 | 1.00 | | | | | |
| Canada | 0.41 | 0.58 | (0.04) | 0.77 | 1.00 | | | | |
| Total Europe | 0.79 | 0.74 | 0.44 | 0.74 | -- | 1.00 | | | |
| Middle East | -- | -- | -- | -- | -- | -- | 1.00 | | |
| Japan | -- | -- | -- | -- | -- | -- | -- | 1.00 | |
| All Countries | 0.75 | 0.67 | 0.37 | 0.82 | 0.71 | 0.95 | 0.13 | 0.38 | 1.00 |
| **Exchange Rates** | | | | | | | | | |
| Sw. Fr./$U.S. Exchange Rate | 0.44 | -- | -- | -- | -- | -- | 0.47 | -- | -- |
| £/$U.S. Exchange Rate | -- | (0.46) | -- | -- | -- | -- | 0.25 | -- | -- |
| DM/$U.S. Exchange Rate | -- | -- | 0.03 | -- | -- | -- | -- | -- | -- |
| Fr. Fr./$U.S. Exchange Rate | -- | -- | -- | 0.28 | -- | -- | -- | -- | -- |
| Can. $/$U.S. Exchange Rate | -- | -- | -- | -- | 0.31 | -- | -- | -- | -- |
| Yen/$U.S. Exchange Rate | -- | -- | -- | -- | -- | -- | -- | (0.05) | -- |
| Trade-Weighted Ex. Rate** | 0.21 | (0.17) | (0.12) | 0.17 | (0.08) | 0.05 | 0.42 | 0.22 | 0.11 |
| **Macro Variables** | | | | | | | | | |
| DJIA | (0.04) | 0.08 | (0.23) | 0.38 | 0.26 | 0.03 | 0.22 | 0.12 | 0.19 |
| S&P 500 | (0.08) | 0.68 | (0.27) | 0.52 | 0.51 | 0.29 | (0.09) | (0.08) | 0.31 |
| Differential, U.S.-OECD Industr. Prod. Indices | (0.22) | 0.40 | 0.15 | 0.24 | 0.26 | 0.15 | (0.20) | 0.43 | 0.16 |
| Avg. Yield, AAA Corp. Bonds | 0.14 | 0.73 | (0.23) | 0.53 | 0.47 | 0.47 | (0.05) | (0.06) | 0.42 |

* Includes: Bahrain, Iran, Iraq, Kuwait, Oman, Saudi Arabia, the United Arab Emirates.

** Based on average spot rates, weighted by the trade share of major countries in U.S. exports and imports and indexed to May 1970.

## Results

A perfect correlation is indicated by a value of 1.0, and no correlation by 0.0. As a rule of thumb, a correlation of 0.30 or greater is significant, and the higher the value, the closer the relationship between two variables.

As noted in past SIA Foreign Activity Reports, Swiss, U.K. and Mideast investors account for a large percentage of foreign portfolio investment in U.S. equities. Despite differences in the degree of responsiveness on the part of foreign investors in different countries to interest and exchange rates, stock prices and levels of economic activity, investment flows from individual European countries are all strongly correlated with aggregate foreign investment and, particularly, capital flows from Europe. The importance of European investment to aggregate capital flows is demonstrated by the high correlation coefficient of 0.95. In other words, like institutional investors in the U.S., net foreign investors develop "similar buy and sell attitudes" towards U.S. equities. This similarity in attitude apparently outweighs the relative importance of various economic factors which should increase or decrease foreign flows.

Investment flows from Switzerland, the U.K. and France each show a correlation of about 0.75 or greater with total European investment. Investment flows from West Germany are also correlated with European flows, albeit somewhat less closely. Canadian and total European investment flows are surprisingly closely correlated. Investment flows from OPEC-member countries, in contrast, show no correlation with European investment in U.S. equities.

Total European investment and, hence, investment from individual European countries is quite closely correlated with aggregate foreign investment from all countries. In contrast, Mideast investment is not significantly correlated with total flows. Of all the important foreign investors, the Mideast oil-exporting nations evidenced little, if any, consistency with investment patterns from other foreign countries.[5] In estimating the direction of aggregate flows based on individual countries, Switzerland and, somewhat surprisingly, France would be the best proxies.[6] On the other hand, levels of investment from OPEC members would yield very little information about aggregate foreign flows.

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[5] Excluding their investment through other financial centers such as London or Zurich.

[6] France traditionally accounts for a relatively small percentage of total foreign investment in U.S. equities.

Aggregate foreign investment is correlated to trends in the S&P 500 and U.S. interest rates. As the correlation matrix shows, levels of aggregate foreign investment are not closely related to movements in the trade-weighted exchange rate, possibly being masked by the impact of interest rate trends on exchange rates. Similarly, investment flows from individual European countries and total Europe are unrelated to changes in the trade-weighted dollar exchange rate. Only Mideast investment moves closely with this variable. This result is not surprising since OPEC member countries rely heavily on the dollar as an international medium of exchange.

On a disaggregated basis, the results suggest that investors domiciled in different countries respond in varying degrees to the set of macroeconomic variables included in the correlation matrix. Swiss investors are more responsive to changes in the Swiss franc/$U.S. exchange rate than are other foreign investors to domestic currency/$U.S. rate trends. Japanese investors respond chiefly to differences in levels of U.S. and OECD industrial production. West German investment in U.S. equities is not significantly correlated with any of the macro variables included in the matrix. Mideast investors, like the Swiss, are most responsive to exchange rate considerations. For investors domiciled in OPEC-member countries, the trade-weighted and Swiss franc/$U.S. exchange rates are the best indicators of levels of portfolio investment.

U.K. and French investors appear to respond to a broader range of variables. U.K. portfolio investment in U.S. equities is mainly correlated with U.S. interest rates and the S&P 500. Foreign portfolio investment from France moves in step with stock price indices, U.S. interest rates and, to a lesser extent, the Frence franc/$U.S. exchange rate.

Currency Fluctuations

The trade-weighted exchange rate is not significantly correlated with total foreign portfolio investment. As the matrix shows, the correlation between exchange rate fluctuations and net foreign investment in U.S. equities is stronger on a bilateral basis for certain countries than on an aggregate basis. Swiss investors seem to be most responsive to currency considerations, with a correlation of 0.44 between net Swiss investment in U.S. equities and the Swiss franc/$U.S. exchange rate (the ratio increases as the dollar strengthens). To a lesser extent, levels of Canadian investment in the U.S. parallel changes in the Canadian dollar/$U.S. rate, and foreign flows from France with the French franc/$U.S. rate.

Mideast investment varies with the trade-weighted and Swiss franc/$U.S. exchange rates. Correlations between these variables are 0.42 and 0.47, respectively. Parallel movements in levels of Mideast investment in U.S. equities and the Swiss franc/$U.S. rate reflect Mideast investors' practice of channeling funds through Switzerland.

At the other extreme, U.K. investors do not appear to be very responsive to exchange rate considerations. However, methodological limitations may explain these results. In 1979, Prime Minister Thatcher lifted U.K. exchange controls, stimulating very substantial inflows into the U.S.[7] However, easing of exchange restrictions coincided with the North Sea oil discovery and, consequently, a strong pound. When changes in two important economic variables which should affect net foreign investment in opposite ways occur simultaneously, the impact of one may be masked with simple correlations.

Interest Rates[8]

Theoretically, there are as many reasons for expecting the relationship between rising interest rates and foreign investment in the U.S. to be negative as there are positive. On the one hand, rising interest rates bolster the value of the dollar viz-a-viz other currencies.[9] All other things constant, a strong dollar makes investment in the U.S. more attractive. However, rising interest rates in the U.S. are generally accompanied by a slackening of economic activity and, hence, a weak stock market. Moreover, with rising interest rates, equity investments lose appeal compared to alternative investment vehicles.

Judging from the correlations, the positive effects of rising interest rates on levels of portfolio investment outweigh the negative. U.K. investment in U.S. equities shows a very strong correlation -- 0.725 -- with average yields on high quality U.S. corporate bond issues. Similarly, French and Canadian investors are responsive to changes in U.S. interest rates, with correlations of 0.53 and 0.47, respectively. Swiss, West German and Japanese investors do not seem to respond to U.S. interest rate trends.

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[7] Since 1979, net U.K. investment in U.S. equities has averaged $565.0 million on a quarterly basis.

[8] As measured by the average yield on Moody's AAA rated issues.

[9] Most European countries have been reluctant to allow domestic interest rates to follow U.S. rates upward because of the associated drop in economic activity and, hence, employment. Consequently, rising U.S. interest rates often translate into widening international differentials, at least in the short run.

Stock Price Trends

Traditionally, foreign investors in U.S. equities have preferred large, well-capitalized issues. Since the latter half of the 1970s, however, foreign investors have been more adventurous, experimenting with smaller issues. This trend is borne out by the correlations. Among the eight countries and regions included in our study, only French investors respond more to changes in the Dow Jones Index than the S&P index. In contrast, levels of portfolio investment in the U.S. from the U.K., France and Canada are closely correlated with changes in the S&P 500 Index.

Interestingly, neither the Dow Jones Industrials nor the S&P 500 are significantly correlated with Swiss investment in the U.S. This pattern may reflect problems of misspecification -- stock price trends in any given period clearly influence expectations, but with some time lag. Moreover, Switzerland is unique in that a large percentage of funds flowing out of the country is not Swiss-owned. For this reason, the important economic relationships are likely to be indirect. For example, it may be that real oil prices are a good indicator of Swiss investment in U.S. equities, owing to Mideast investors' use of Swiss Banks.[10]

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10 Fluctuations in the level of Mideast investment in U.S. equities probably stem primarily from shifts in OPEC members' budget constraints as oil prices rise and fall.

## Identifiable Transitory Variables

### The Mideast Investor -- Oil Surplus

Until 1974, investors and intermediaries from Switzerland and the United Kingdom had been the major foreign buyers of U.S. corporate equities. However, in 1974-77 with the rapid build-up of oil wealth, the Mideast oil-exporting countries dominated foreign buying. Net purchases of U.S. equities by the oil-producing countries reached a record $1.8 billion in 1976. The strength of the dollar, a recession in Europe and Japan, and low interest rates on the traditional investment vehicle of these countries -- U.S. government securities -- were responsible for this record investment. Purchases of U.S. equities by Mideast oil-exporting countries, while still significant in absolute terms, waned as a percentage of total foreign net purchases in recent years.

Substantial purchases were made by European investors in 1980-81. Nevertheless, in these two years, net purchases of U.S. equities by the oil-exporting countries totaled about $2.4 billion or about 21.4% of total net foreign purchases. There are several reasons which may explain the diminishing interest of the Mideast in U.S. equities. First, given the record high return on U.S. Treasuries, the oil-exporting countries shifted substantial funds to these issues. Secondly, the diversification into U.S. equities began when the wealth of the oil-exporting countries was growing at a phenomenal rate. Industrialized countries have been successful in recent years in reducing oil consumption. Together with the resultant lowering of real oil prices, forecasts of surpluses for the oil-exporting countries in coming years have been sharply curtailed. Reduced surpluses translate into less funds to invest in U.S. equities.

Table V

Relative Importance of OPEC and European Investors
($ millions)

| | Net Purchases | Net Purchases by Oil-Exporting Countries | % of Total Net Purchases | Net Purchases by Europe | % of Total Net Purchases |
|---|---|---|---|---|---|
| 1973 | $2,790 | $ 60 | 2.2% | $2,119 | 75.9% |
| 1974 | 540 | 361 | 66.9 | 281 | 52.0 |
| 1975 | 4,678 | 1,649 | 35.3 | 2,490 | 53.2 |
| 1976 | 2,753 | 1,803 | 65.5 | 336 | 12.2 |
| 1977 | 2,675 | 1,390 | 52.0 | 1,006 | 37.6 |
| 1978 | 2,423 | 781 | 32.2 | 1,283 | 53.0 |
| 1979 | 1,679 | 658 | 39.2 | 217 | 12.9 |
| 1980 | 5,418 | 1,206 | 22.3 | 3,108 | 57.4 |
| 1981 | 5,761 | 1,174 | 20.4 | 3,523 | 61.2 |

Source: U.S. Treasury

The U.K. Investor -- Lifting of Exchange Controls

In late 1979, the U.K. lifted exchange controls on residents' outflow of funds. Since that time, there has been a notable and sustained interest in U.S. equities. U.K. investors had shown considerable enthusiasm for U.S. equities in the past but, in dollar terms, the levels of 1980-81 have been exceptional. The immediate effect of the elimination of the controls was clear: "Indeed, net investment in British financial institutions in foreign company securities in the first quarter of 1980 was over 4 times the level for the same period in 1979 and 38% more than their investment in British companies."[11] Net purchases by U.K. investors were $1.2 billion in 1978 and $1.0 billion in 1979. These purchases spurted to $2.5 billion and $2.2 billion in 1980 and 1981. Regression equations showed that a variable reflecting the change in U.K. exchange controls was statistically significant in affecting the amount of U.S. equities bought.

French Investors -- National Elections

In the second quarter of 1981, French investors purchased U.S. equities with unprecedented enthusiasm. Net purchases jumped to $560 million from $210 million in the previous quarter, with $392 million of net purchases recorded in May alone. May was national election time in France, and economic and political turmoil ensued in the immediate wake of Francois Mitterrand's victory, France's first Socialist president in 23 years. Although other factors, such as a strong dollar and a plummeting franc, tended to attract foreign capital flows to the U.S, there was a discernible outpouring of capital from France that boosted investment in U.S. equities to an all-time quarterly high, not seen since.

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11 "Overseas gluttons," The Economist, October 11, 1980, p. 93.

## Conclusion

For whatever reason, it is clear that the importance of foreign investment in the U.S. is increasing. We estimate that foreign transactions make up 10% - 12% of all public transactions on U.S. stock exchanges. To some extent, both qualitative and quantitative factors can be found that explain trends in foreign investment in U.S. equities over the years. Although foreign investors from various countries respond differently to trends in macroeconomic variables, investment flows from individual European countries are all strongly correlated with aggregate foreign investment and, particularly, capital flows from Europe. However, of all the major foreign investors, flows originating directly from the Mideast oil-exporting nations evidenced little, if any, consistency with investment patterns from other countries. In other words, foreign investors with the exception of the Mideast, like institutional investors in the U.S., develop similar buy and sell attitudes towards U.S. equities.

The correlation coefficients presented in this paper indicate that investment from the U.K., France and Canada are affected by trends in the S&P 500. An informal telephone poll of SIA members indicates that recent interest from the United Kingdom has been particularly strong. Whether or not such interest continues depends, of course, on developing trends in stock market prices.

Jeffrey M. Schaefer
Senior Vice President
& Director of Research

Carolyn Hildebrandt
Associate Director
of Research

Elizabeth Rosenthal
Research Associate

# SECURITIES INDUSTRY STATISTICS

VOLUME

| | June 1982 | YEAR-TO-DATE 1982 | June 1981 | YEAR-TO-DATE 1981 | % CHG. Y-T-D 1982 - 1981 |
|---|---|---|---|---|---|
| AVERAGE DAILY SHARE VOLUME ON | | | | | |
| NYSE (MILS.)* | 50.5 | 51.8 | 50.0 | 48.6 | 6.6% |
| AMEX (MILS.)* | 3.7 | 4.2 | 6.0 | 5.8 | (27.6) |
| NASDAQ (MILS.)* | 24.9 | 27.3 | 34.7 | 32.5 | (16.0) |
| REGIONAL EXCHANGE (MILS.)* | 6.8 | 7.3 | 6.7 | 6.1 | 19.7 |
| DOLLAR VALUE OF SHARES TRADED ON | | | | | |
| NYSE (MILS.) | 30,699 | 182,658 | 36,514 | 208,886 | (12.6) |
| AMEX (MILS.) | 895 | 6,605 | 2,251 | 13,594 | (51.4) |
| ODD-LOT SHARES PURCHASED ON NYSE (THOUS.) | 4,416 | 27,588 | 5,905 | 34,044 | (19.0) |
| ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.) | 9,173 | 57,341 | 12,467 | 72,556 | (21.0) |
| NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED | 42.7 | 39.8 | 34.7 | 31.0 | 28.4 |
| CONTRACTS TRADED (THOUS.) | | | | | |
| CBOE OPTIONS | 5,345 | 31,791 | 4,343 | 26,211 | 21.3 |
| AMEX OPTIONS | 2,751 | 15,951 | 2,679 | 16,215 | (1.6) |
| COMMODITY | 9,766 | 52,014 | 8,481 | 47,509 | 9.5 |

* *MONTHLY AVERAGE*

## YIELDS

(MONTHLY AVERAGES)

| | June 1982 | June 1981 | Basis Point Change |
|---|---|---|---|
| BOND BUYER INDEX (20 BOND) | 12.45 | 10.71 | 1.74 |
| CORPORATE BOND YIELDS (MOODY'S) | | | |
| Aaa CORPORATE | 14.81 | 13.75 | 1.06 |
| Baa CORPORATE | 16.92 | 15.80 | 1.12 |
| RATIO Aaa CORPS. TO Baa CORPS. | 0.88 | 0.87 | 0.01 |
| MUNICIPAL BOND YIELDS (MOODY'S) | 11.55 | 9.86 | 1.69 |

## PRICES

(END OF MONTH)

| | June 1982 | June 1981 | % Change Year to Year |
|---|---|---|---|
| DOW JONES INDUSTRIALS | 811.93 | 976.88 | (16.9)% |
| STANDARD & POOR'S 500 | 109.61 | 131.25 | (16.5) |
| NYSE COMPOSITE | 63.02 | 76.15 | (17.2) |
| AMEX MARKET VALUE INDEX | 250.79 | 374.63 | (33.1) |
| VALUE LINE COMPOSITE | 120.57 | 154.99 | (22.2) |
| NASDAQ COMPOSITE | 171.30 | 215.75 | (20.6) |

## UNDERWRITING
## (DOLLARS IN MILLIONS)

| | June 1982 | Yr.-to-Date 1982 | June 1981 | Yr.-to-Date 1981 | % Change Jun'81-Jun'82 | % Change Yr.-to-Date |
|---|---|---|---|---|---|---|
| **CORPORATE FINANCING (Gross New Issues)** | | | | | | |
| Total | 3,187 | 25,639 | 9,329 | 34,559 | (65.8)% | (25.8)% |
| Competitive | 139 | 1,573 | 729 | 3,263 | (80.9) | (51.8) |
| Negotiated | 3,048 | 24,066 | 8,600 | 31,297 | (64.6) | (23.1) |
| Common Stock | 763 | 4,548 | 2,862 | 9,689 | (73.3) | (53.1) |
| # Of Common Stock Issues | 41 | 253 | 111 | 511 | (63.1) | (50.5) |
| Preferred Stock | 165 | 1,894 | 133 | 1,182 | 24.1 | 60.2 |
| # Of Preferred Stock Issues | 3 | 32 | 5 | 26 | (0.4) | 23.1 |
| Corporate Debt | 2,260 | 19,197 | 6,333 | 23,687 | (64.3) | (19.0) |
| # Of Corporate Debt Issues | 29 | 200 | 59 | 236 | (50.8) | (15.3) |
| | **July 1982** | **Yr.-to-Date 1982** | **July 1981** | **Yr.-to-Date 1981** | **% Change Jul'82-Jul'81** | **% Change Yr.-to-Date** |
| **MUNICIPAL FINANCING* (Gross New Issues)** | | | | | | |
| Total | 8,587 | 61,04? | 5,522 | 44,139 | 55.5% | 38.3% |
| Notes | 3,186 | 25,251 | 2,267 | 18,365 | 40.5 | 37.5 |
| Bonds | 5,401 | 35,798 | 3,255 | 25,774 | 65.9 | 38.9 |
| # of Bond Issues | 313 | 2,689 | 369 | 2,524 | (15.2) | 6.5 |
| Negotiated Bonds | 4,020 | 24,340 | 2,213 | 14,942 | 81.7 | 62.9 |
| Revenue Bonds | 4,400 | 24,160 | 2,152 | 16,854 | 104.5 | 43.3 |

*Preliminary Figures

MUTUAL FUNDS
(DOLLARS IN MILLIONS)

| | June 1982 | Year-to-Date 1982 | June 1981 | Year-to-Date 1981 | % Change, Y-T-D '82 to Y-T-D '81 |
|---|---|---|---|---|---|
| NET SALES* | 383.0 | 1,923.8 | 52.0 | 888.0 | 1.17% |
| NET PURCHASE OF COMMON STOCK* | 266.6 | (530.5) | (176.9) | (232.4) | ---- |
| NET PURCHASE OF OTHER SECURITIES* | (186.1) | 542.4 | 373.3 | 1,092.5 | ( 50.4 ) |
| MUTUAL FUND CASH POSITION | 13.5 | ---- | 9.7 | --- | ----- |

*EXCLUDES MONEY MARKET, MUNICIPAL BOND AND OPTION FUNDS

MARGIN DEBT

| | June 1982 | June 1981 | % Change Jun'82--Jun'81 |
|---|---|---|---|
| MARGIN DEBT OUTSTANDING ($MILS) | 11,540 | 14,870 | (22.4)% |
| NET CHANGE IN MARGIN DEBT ($MILS) | (3,330) | 3,670 | 9.3 |
| % OF ACCOUNTS WITH EQUITY UNDER 40% | 12% | 13% | ---- |

FINANCIAL DATA FOR NYSE FIRMS DOING A PUBLIC BUSINESS
(MILLIONS OF DOLLARS)

| | First Quarter 1982 | Yr.-to-Date 1982 | First Quarter 1981 | Yr.-to-Date 1981 | % Change 1st Q.1982 1st Q.1981 | % Change Yr.-to-Date 1982-1981 |
|---|---|---|---|---|---|---|
| REVENUE | | | | | | |
| SECURITIES COMMISSION INCOME | 1,157 | 1,157 | 1,373 | 1,373 | (15.7%) | (15.7%) |
| REALIZED AND UNREALIZED GAIN OR LOSS IN TRADING AND INVESTMENT | 1,072 | 1,072 | 1,366 | 1,366 | (21.5%) | (21.5%) |
| PROFIT OR LOSS FROM UNDERWRITING AND SELLING GROUPS | 360 | 360 | 350 | 350 | 2.9% | 2.9% |
| TOTAL REVENUE | 4,535 | 4,535 | 4,861 | 4,861 | ( 6.7%) | ( 6.7%) |
| TOTAL EXPENSES | 4,365 | 4,365 | 4,193 | 4,193 | 4.1% | 4.1% |
| NET INCOME BEFORE TAXES | 170 | 170 | 668 | 668 | (74.6%) | (74.6%) |
| PERCENT OF FIRMS SHOWING LOSS | 42.7% | 42.7% | 16.2% | 16.2% | --- | |

## RECENT INTERESTING READING AND STATISTICAL MATERIAL

| ITEM | DESCRIPTION | SOURCE |
|---|---|---|
| "The Reverberations of the Drysdale Crash" | An account of the incident and its aftermath. Some important developments include changes in the method of valuing securities in repurchase agreements and a renewed cautiousness on the part of institutions with securities to lend. | Euromoney July, 1982 |
| "Beggared Banks" | A chronicle of the troubles which Canadian, U.S., West German and, last but definitely not least, Italian lending institutions have recently faced. The progressively closer ties between national banks suggest that the day for a world central bank -- or, on a more modest scale, closer coordination among national bank supervisors -- has arrived. | The Economist July 24, 1982 |
| "Upheaval in Investment Banking" | The pros and cons of shelf registration six months after its temporary adoption, and some new twists -- and large losses -- on recent bought deals. | Fortune August 23, 1982 |
| "The New World of Corporate Finance" | Advantages of Rule 415 for corporate treasurers, particularly those of large companies, and some unanswered questions: the naming of underwriters, procedures for ensuring due diligence and the impact of shelf registrations on equity prices. | Dun's Business Mon August, 1982 |
| "The Future of the Financial Services Industry" | Changes in consumer needs, technology and the regulatory environment, and the financial services industry's response. | Financial Analysts Journal July/August, 1982 |
| "Citibank Offers Service for Soft Dollar Payments" | Details of an arrangement whereby master trust clients of Citibank are given the opportunity to pay for performance evaluation via a commission pass-through. | Pensions & Investm Age August 2, 1982 |

| ITEMS | DESCRIPTION | SOURCE |
|---|---|---|
| "The Troika Spawns a Whole New Business" | As the number of developing countries facing debt rescheduling problems climbs higher, so too has a new source of fee income to investment and merchant banks: advising LDCs on liability management problems and other financial issues. | Euromoney August, 1982 |
| "Realities of Bank Taxation" | Rebuttal by a V.P. of Chase Manhattan Bank to frequent claims that the bank's tax burdens are unduly meager. In essence, the author argues for a broader definition of taxes and points out that commercial banks function chiefly as tax intermediators. | Tax Notes July 19, 1982 Vol. XVI, No.3 |
| "Securities Industry Association Critiques Compliance Legislation" | Letter from SIA's president to the Chief of Staff of the Congressional Joint Committee on Taxation outlining some key concerns re: reporting of gross proceeds as required by H.R. 6300. | Tax Notes July 12, 1982 Vol. XVI, No.2 |
| "Paper Gains in Covering Pension Fund Liabilities" | Write-up of Business Week's annual survey of pension liabilities, some cautions about present methods of calculating pension assets and the FASB's plans re: reporting of pension obligations as liabilities in financial statements. | Business Week August 9, 1982 |
| "Financial Innovation and Monetary Policy" | The driving forces behind financial innovations and implications for monetary policy as the dividing line between money and other financial assets fades and money demand becomes more erratic. | Federal Reserve Bulletin July, 1982 |